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ABSTRACT

This report examines the Tennessee state-local tax structure to determine whether tax inequities have given rise to a situation in which taxes have contributed to an inadequate or inequitable flow of financial resources to the public schools. It investigates the possibility that some structural changes in the tax system might improve both tax equity and the distribution of funds to the schools. After an introductory chapter, chapters 2-4 define elements of a high quality tax system and ideal state-local intergovernmental relationship and then evaluate the Tennessee tax system according to these precepts. Chapter 5 discusses Tennessee's major state and local taxes in detail. Chapter 6 proposes alternatives to some tax and intergovernmental fiscal programs. In the proposals, a portion of the taxing responsibility is shifted from the local jurisdictions to the state. State funds are then suggested for transfers to local units, either on the basis of local tax relief, or of burden and effort equalization. Sufficient funds should be reserved for equalization purposes, with the remainder used for general relief of local taxes. This process, if carried to the ultimate, should equalize jurisdictional tax efforts and individual tax burdens. (Author/IRT)

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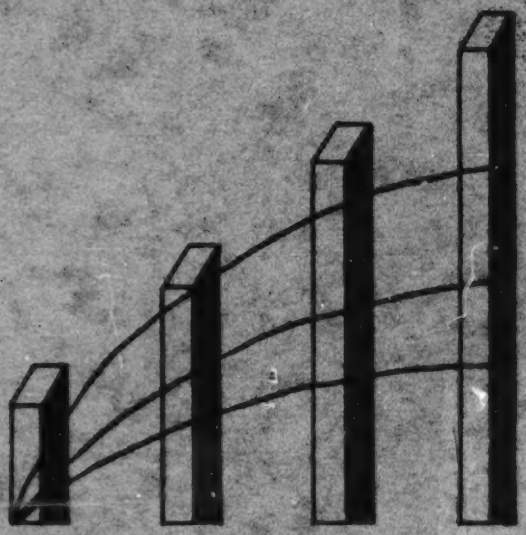

prepared for the

TENNESSEE SCHOOL FINANCE EQUITY STUDY 1978 – 1979

EA 012 292

A PRELIMINARY REPORT ON THE TENNESSEE STATE-LOCAL TAX SYSTEM WITH REFORM PROPOSALS

Prepared by

The Center for Business and Economic Research
The College of Business Administration
The University of Tennessee, Knoxville

For

The Tennessee School Finance Equity Study

Nashville, Tennessee 1978

FOREWORD

This report is the product of one in a series of studies initiated by the Tennessee School Finance Equity Study Project as part of a detailed review of the State's program for financing the public schools, kindergarten through grade twelve. It presents pertinent background data and information evaluating the State-local tax system and includes reform proposals. Neither the findings, the implications, the conclusions, nor the recommendations are necessarily those supported by the Study Project, the State Department of Education, or the Joint Legislative Committee on Elementary/ Secondary School Finance all of whom are cooperating in sponsoring the overall study. This report represents a part of a larger body of knowledge which is being gathered by the Study Project so that viable alternatives can be examined and considered upon their merits. This study along with others conducted for the School Finance Equity Study Project is funded by the U.S. Office of Education, Department of Health, Education and Welfare, under Section 842 of P. L. 93-380. However, the opinions expressed do not necessarily reflect the position or policy of the U.S. Office of Education.

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A REPORT
ON THE TENNESSEE STATE-LOCAL TAX SYSTEM-
WITH REFORM PROPOSALS

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CHAPTER I

PURPOSE, SCOPE AND ORGANIZATION OF THE REPORT

Introduction

This report is one phase of the Tennessee Public Education Finance Study. In this, as in any school finance program, there are two readily accepted goals: (1) to equalize educational opportunities for all pupils enrolled in the state's public schools and (2) to provide an equitable tax system for financing public education. The balance and comprehensiveness of the state and local tax system has impact on both the equality of educational opportunity and taxpayer equity. Educational opportunity cannot be dispensed equally if fiscal resources are distributed in a manner disproportionate to financial needs. Deviations from taxpayer equity have an adverse effect on the manner in which fiscal resources are distributed. Since state and local taxes support the public schools, both have an impact on the equality of educational opportunity and taxpayer equity.

This report focuses on the second of the two goals stated above--an equitable tax system. Its purpose is to examine the Tennessee state-local tax structure to determine whether tax inequities have given rise to a situation in which taxes have contributed to an inadequate or inequitable flow of financial resources to public schools. It investigates the possibility that some structural changes in the state-local tax system might improve both tax equity and the distribution of funds to the public schools in Tennessee. It recognizes that if suboptimal use of the state's taxable resources occurs, neither tax equity nor equality of educational opportunity can be achieved. The incidence of taxes in

our economic system must be at just the right place and in the right amounts--on consumption, earnings, production and wealth.

The state has both the moral and the legal responsibility to provide equality in funding public school expenditures. As in most other states, some of the fund-raising duties are delegated to the local school systems, but local jurisdictions are limited in their taxing authority. Consequently, they are forced to depend largely on property taxes and other regressive revenue-raising sources. In this respect the state's delegation of financial responsibilities is unequal. It achieves inequitable results because school districts vary in their ability and commitment to finance public education. Inequalities in educational opportunities result partly because of these differences and partly because state aid programs have failed to offset these differences in local resource levels. The widespread use of property and consumption taxes at the local level and of consumption taxes at the state level raises concerns that the state-local tax system does not provide an equitable nucleus for financing public education, or for that matter, any public service.

Origin of the Report

The Serrano decision on August 30, 1971, and a series of later court cases challenging school finance programs are responsible for a number of school finance studies and, perhaps indirectly, for this Tennessee study. In a follow-up to the original Serrano decision, the California Supreme Court (April 10, 1974) held that fiscal disparities in terms of school district tax burdens violated the equal protection

provisions of the state constitution.[1] In March 1973, the U. S. Supreme Court ruled that the Texas public financing system, depending largely on local property taxes, did not violate the Fourteenth Amendment to the U.S. Constitution even though wealthy districts could provide a higher quality of education with lower local tax rates than could a less affluent school district.[2] Public school financing recently has been found to violate state constitutions in several states.[3]

The impact of these decisions has been far-reaching. The possibility that state and local school financing systems violate state constitutions has made the problem of reducing intrastate disparities in school financing an issue of prime importance to public policy makers.

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1. Serrano vs. Priest, California Supreme Court 938254 L.A. 29820 (1971), p. 1. On April 10, 1974, the California court held that the state's current plan for financing public schools through local property taxes raised by school districts having widely varying tax bases, including 1972 and 1973 property tax relief legislation, violates the state constitution's equal protection provisions because it denies equal educational opportunities to public school students. In Clowes vs. Serrano, Docket No. 76-1512, June 20, 1977, the U.S. Supreme Court denied a petition for certiorari challenging the decision. The California court also stated that the U.S. Supreme Court's 1973 holding in Rodriguez had no conclusive effect upon the California decision since the state constitutional ground was sufficient to support the California decision. The fact that the federal court did not view education as a fundamental right has no effect upon California's construction and application of the state constitution's provisions.

2. San Antontio Independent School District vs. Rodriguez.

3. Decisions have been reached in Connecticut, Texas, New York, New Jersey, Minnesota and Michigan. The latest was in Connecticut on April 19, 1977 (Horton, et al. vs. Meskill, et al.). The Court decided that public education is a fundamental right, and that the state's system of financing such education via the local property taxes does not meet Constitutional equal protection guarantees. In another recent decision, Seattle School District No. 1 of King County, et al. vs. State of Washington, the Superior Court held that the system for financing public schools in the state via property taxes violates the state's constitutional ample education requirement in that one-third more money may be spent in any given district depending on whether voters approve a special excise tax levy for education. The case will be appealed to the Washington Supreme Court.

Even in the absence of pending court cases, taxation has become a highly visible source of inequalities in the distribution of public services, including public education.

A further encouragement to education finance studies is found in Section 842 of Public Law 93-380. That law encourages each state to develop plans to provide a program of education financing which is consistent with the standards set out in the equal protection clause of the Fourteenth Amendment to the U.S. Constitution. Its purpose is to promote equality of educational opportunities for all pupils in attendance in the public schools of a state with substantially equal tax rates among school districts and substantially equitable tax burdens among the state's taxpayers.

Established guidelines for program development include both equalization of education expenditures and equalization of tax burdens and efforts. Local financial programs should be supported through substantially equal tax rates on local taxable resources. The state financial assistance programs should substantially equalize total financial resources of the school districts and be financed by equitable state taxation.

Objectives of the Report

The primary emphasis of this phase of the report is on equity in taxation. In this respect it will evaluate the current state-local tax system and suggest and evaluate alternative programs that will strengthen equity. While the guidelines set out in Section 842, Public Law 93-380 do not specifically mention the tax system as it supports noneducation public functions, financing education and noneducation programs cannot be separated. Taxes are intermingled for many functions and tax equalization is similarly multifaceted. Consequently this report can be

classified most accurately as a study in tax equity.

In this broad context the report is concerned with many aspects of tax equity. Especially implicit in the report is the fair treatment of every taxing jurisdiction and every taxpayer. Closely akin to equity in outlining a satisfactory tax system is adequacy to meet current financial needs, responsiveness to meet future needs, simplicity of administration and compliance, and compatibility with economic and social development. All these must be met if a tax system is to be "ideal." The present Tennessee tax system and alternatives are evaluated, using these criteria as measuring sticks.

Sometimes, however, these goals may be contradictory. The ultimate goal, then, is to suggest a tax system that meets a maximum number of these objectives and that has as few "trade-offs" as possible between the objectives.

Scope of the Report

This report discusses in detail (1) the major state and local taxes currently employed in Tennessee, (2) the total state and local tax system employed in Tennessee including intergovernmental fiscal relationships and transfers and (3) alternative state and local tax systems. Taxes and tax systems will be evaluated in terms of adequacy, equity, simplicity and effects on economic and social development. These are the criteria that characterize a tax or tax system as being of high or low quality. Some "trade-offs" are necessary, however, because these goals are sometimes in conflict.

The inadequacies of the current tax system in no way reflect negatively on the performance of past state and local officials. Most state

and local tax systems, largely prepared for periods of low public activities and rather simple economic systems, were no doubt well designed for the time and purposes.

Systems basically designed decades ago are not appropriate for periods of sustained and high public and private economic activity and complex economic interrelationships. Current systems are, in part, the product of ad hoc piecemeal changes designed to meet changing needs. Unique tax concessions for strong special interest groups also gradually infiltrate state and local tax systems and create equity problems. While it is not the purpose of this report to categorically state that these things have occurred in excess, the study alternatives respond to them if they are present. This study then offers comprehensive alternatives for general modernization of taxation in weak areas in line with current research findings and needs. This comprehensive and coordinated review and adjustment is more satisfactory than further "patching up" of a possibly outdated tax system.

Organization of the Study

Any study of taxation must start with clearly defined concepts and goals in mind. This one is no exception. Moreover, before any tax alternatives can be advanced, the current system must be evaluated in terms of the concepts and goals. In Chapters II, III and IV elements of a high quality tax system and ideal state-local intergovernmental relationships are defined and the Tennessee state-local tax system evaluated according to these precepts.

In addition to the other objectives set out in the proposals, the major concern of tax policy reform deals with two elements of tax equity.

The first is the distribution of interjurisdictional tax effort. The second is the distribution of the interpersonal tax burden. In both cases opinions differ as to whether the effort and burden distributions should be regressive, proportional or progressive.

It is generally held in this report that taxes should bear equally on the capacity of all taxpayers (proportional according to total income). It is also implied that each jurisdiction should employ its tax effort up to its ability as measured statistically in order to be eligible for state financial assistance. This effort, plus state financial assistance, should maintain an adequate local service level.

Chapter V discusses Tennessee's major state and local taxes in detail. Each major tax (property, individual and corporation income and general and selective sales taxes) and other minor taxes (licenses and fees) are evaluated separately and in relation to the total tax system. Statistical comparisons are made with similar taxes in other states. It should be kept in mind throughout the discussion that each tax operates within the framework of the overall tax system. Strengths and weaknesses are evaluated in regard to their relative contribution to the total tax system.

In view of the discovered strengths and weaknesses of the state-local tax system as measured by the criteria in Chapter II, the discussion in Chapter VI proposes alternatives to some tax and intergovernmental fiscal programs. They are designed to improve the overall structure of the state-local tax system.

In the proposals a portion of the taxing responsibility is shifted from the local jurisdictions to the state. State funds are then suggested for transfers to local units, either on the basis of local tax relief or

burden and effort equalization. Sufficient funds should be reserved for equalization purposes (both for school purposes and general government purposes), with the remainder used for general relief of local taxes.

This process, if carried to the ultimate should equalize jurisdictional tax efforts and individual tax burdens. Taxpayers are not equally capable of paying this average jurisdictional tax rate. Therefore, after jurisdictional equalization is accomplished, funds should be available to equalize individual tax burdens. While some progress toward this final objective should be encouraged, complete proportionality in the state-local tax system in the absence of an individual income tax is virtually impossible.

CHAPTER II

BASIC CRITERIA OF A STATE-LOCAL TAX SYSTEM

Introduction

A primary purpose of government is to balance the sometimes conflicting economic and social interests and needs of the citizens. Their well-being and the economic and social development of the state depends on the relative (optimum) size of the public sector and also on the method of raising public funds and the priorities for spending them.

Government must take resources from the private sector in order to support the public sector. Taxation is the system whereby citizens pay the costs of government. The allocation of resources and the distribution of public services is provided through the combined workings of the economic and political system.

One of the major preoccupations within the public sector in recent years is equitable distribution of the benefits and costs of government. In keeping with this, Section 842 of Public Law 93-380 directs the states to develop an equitable financial plan to support public education. This equity concept is combined in the "wealth neutrality" principle used commonly by educators. "Wealth neutrality" is based on the principle that for an equal effort, an equal proportion of the jurisdictional wealth bases and equal available public resources (taxation supplemented with fiscal transfers) is available to equalize the opportunity to enjoy public services (adjusted for variations in need).[1] The principle

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1. On the tax side of the benefit-cost equation, the "wealth neutrality" principle can be assumed to include all the primary tax criteria such as adequacy, equity, efficiency and simplicity, that are discussed later.

has validity for either interjurisdictional or interpersonal costs and benefits of government.

Meeting these requirements places a heavy demand on public planners. Government activities both reduce the potential for public well-being (taxation) and increase it (expenditures). These activities must be coordinated to achieve maximum public well-being, which is the basic goal of government. The tax system must be structured so as to minimize the reduction in well-being. On the other hand, expenditure priorities must be structured to optimize the benefits of public expenditure. Thus net benefits are maximized.

One point needs to be made clear at the outset: all forms of taxes must be evaluated jointly as well as separately. Tax dollars cannot be realistically dedicated to a particular function and the forms of those taxes cannot be evaluated in isolation. But while taxes must be evaluated according to aggregate level, economic influence and burden distribution, each tax must also be rated in relation to its contribution to the overall tax system. So while the study is basically a school finance study, the total state-local finance structure must be evaluated.[2]

No tax or tax system can be evaluated without a clear understanding of the evaluating criteria. While tax equity is the most conspicuous

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2. Implied in the process of providing equal access to public services at substantially equal burdens is the concept of intergovernmental fiscal transfers. One of the basic principles of budgeting is that resources be matched with responsibilities. In our federal system administrative responsibilities are divided between state and local governments. So also must the resources be divided to finance the services. Intergovernmental fiscal transfers must be investigated. Available resources after transfers need to be optimally matched with administrative needs and responsibilities of the state and local governments and with their respective abilities. This concept of fiscal transfers is investigated in Chapter III.

criterion to be considered, one must add the criteria of adequacy, efficiency and simplicity. In this chapter, each of these criteria is briefly defined. Prior to this, however, a brief theoretical description of the need for and the size and scope of government is attempted.

The Need for Government

The basic economic problems in society are the scarcity and the allocation of economic resources. The primary producer and allocator of goods and services is the private economy. Individuals and business firms largely determine how and in what quantity goods get produced and distributed and how human and natural productive resources get developed.

However, private market allocative and developmental solutions are not applicable in some areas of production and distribution (e.g., highways and streets). In other areas complete dependence on private market decisions would result in an undesirable level of production (e.g., education). In still other areas, private sector allocations under modern economic and social arrangements have undesirable results that restrain economic well-being and development (e.g., business cycles, monopolistic tendencies and natural resource misuse and conservation). Recognized private sector inadequacies must be minimized or removed and private sector production reinforced by an active public sector if economic well-being is to be maximized.

Public sector allocation is accomplished through the revenue and expenditure policies of government. The performance of the private sector influences the public sector and the public sector influences the performance of the private sector. The allocation of economic tasks

between the two sectors determines the performance of the total economy. Economic and political forces interact to determine the relative size of each sector. This is the subject of the following section.

The Size and Scope of Public Activity

Both the private and public sector decisions are guided by common economic and social objectives. Public sector decisions affect and are affected by private sector decisions. The public sector reacts to the inadequacies of the private sector. In turn government decisions directly or indirectly affect resource allocation, development and distribution. If the decisions that affect the economy are appropriately allocated, society achieves a balance that would be unachievable in the absence of either sector.

The political nature of public decisions does not place them beyond economic analysis. Public decisions shift the control or use of economic resources from the private to the public sector; the economic causes and consequences must be reckoned with. This offers an economic basis for determining the proper division of duties between the private and public sectors.

Quite simply, the sectorial division of functions is based on two propositions: first, the public sector should maximize public welfare by controlling or supplementing only those private economic activities that serve to maximize public well-being; second, the dollars taken in taxation to support the public sector should be distributed in a way that minimizes the reduction in well-being in the private sector.

The cost of government, assuming full employment of economic resources, is measured by the resources surrendered by the private sector (in

taxes) to pay for government goods and services. Costs can be measured in dollar terms (of taxation), but they are more accurately measured in terms of the value of the dollars surrendered. That is, the cost of government varies according to whose dollars get taken in taxation as well as according to the number of dollars. A dollar in taxation taken from a low-income family has a different effect on economic welfare than does a dollar taken from a wealthy family. A dollar taken from a business firm may have an effect widely different from one taken from an individual.

Two approaches have been employed by economists to demonstrate theoretically the optimum size of the public sector. This optimum intersectoral allocation of functions can be demonstrated with the use of indifference curves or by marginal utility analysis. They are each described briefly in Appendix A to this paper.

Both approaches require that the preferences of society and society's evaluation of the utility of additional units of private and public goods and services can be measured. Since they cannot be accurately calculated, the optimal points can only be approximated. Optimal intersectoral allocation of resources is roughly approximated because the citizens reveal their preferences for public, quasi-public and private goods and services through their spending and voting patterns. These preferences are discovered and honored through the political process.

The proper distribution of public services (by government level and by type of activity) maximizes the benefits derived from public spending. The proper distribution of private costs (taxes) to finance public spending minimizes the welfare loss to the private sector.

In summary, the citizens' demands (priorities) for public goods and services and their willingness to pay for them collectively determine the relative size of the public sector. The payment for the public goods and services is distributed among the elements of society by the form the tax system takes. The form the tax system takes determines the disutility suffered for paying for public services and influences the relative size of the public sector. A well-designed tax system minimizes private sector utility loss due to taxation. Reducing the welfare loss is the primary purpose of any effort to restructure a tax system.

The Proper Government Level for Administering Public Functions

As a general rule each public service should be administered by the unit which most closely encompasses the area over which public benefits are distributed. This, in effect, states that functions of a national interest should be financed and administered on a national scale; functions which are of a state or local interest should be financed and administered at the state or local level. In some cases interests are dispersed among the different governmental levels and all should share in the financing and decision making.

The division of taxing responsibilities between state and local governments depends on (a) the distribution of administrative responsibilities and (b) the ability of local governments to levy taxes according to established principles of efficiency and fairness. Local governments must be able to secure revenues commensurate with administrative responsibilities, either through local application of taxes or through sharing of state and federal revenues. As an economy becomes more complex and

interdependent, service areas tend to expand.[3] Traditional local services become state and national responsibilities. Given that administration is retained at the local level, as the service area expands, it becomes necessary to expand the financing area. It becomes increasingly rational to raise larger portions of state and local taxes with statewide application. Moreover, as economic interdependence spreads, it becomes increasingly less efficient to collect taxes in small political jurisdictions.

Elements of a High Quality Tax System

Adam Smith in his Wealth of Nations put forth the assumption that taxpayers would be more willing to support the public sector if public officials were guided by the criteria of equity, certainty, economy and taxpayer convenience in establishing the tax system. If taxpayers are convinced that policy makers are adhering closely to such principles, then the tax system would be acceptable and the loss of welfare due to the surrender of private economic resources to finance public production would be minimized.

Adherence to these principles is complicated by various factors. In a federal system of government with its complex system of administrative and financial responsibilities, it is difficult to assess and generalize as to the overall economic and social effects of taxation. While federal taxation can be assumed uniform in the nation, state tax

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3. This cannot always be assumed. In a limited number of cases, as society becomes more complex, the population becomes more heterogeneous, and local administration becomes a more logical means of providing a package of public services that better suits local conditions. The original statement remains true for major functions such as education, highways and, more recently, environmental regulations.

systems differ by significant degrees. Even within states, the range of differences in local taxes and tax systems is exceedingly broad.

Nevertheless, an attempt to generalize on principles for evaluating a state-local tax system is worthwhile. This section discusses some important guidelines, following closely the principles of adequacy, equity, efficiency and simplicity.

Adequacy can be defined in relation to the size and growth rate of the state economy.[4] The relative size of the public sector is determined through the economic and political processes. Tax revenues must be adequate to meet current public expenditures. The tax revenues grow naturally as economic activity grows. They should grow rapidly enough to finance expenditure needs without the need for frequent rate and base changes. The relationship of the growth of taxes to the growth in the economy (responsiveness or elasticity)[5] depends on the type of taxes making up the system. Taxes and tax systems can be responsive, unitary or unresponsive, depending on whether revenues grow at a rate in excess of, equal to or less than the growth of the private economy. Whether a state-local tax system should be progressive, proportional or regressive in distribution is a matter of speculation. Most economists believe state-local taxation should be proportional or near-proportional and

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4. Adequacy consists of two factors: productivity and responsiveness to economic change.

5. Elasticity is measured as $E = \frac{\text{Percent Change in Taxes}}{\text{Percent Change in Economic Activity}}$. If the ratio is greater than one, a tax system is said to be elastic. Tax revenue grows at a rate greater than that of the economy and the public sector becomes a larger proportion of the state economy. If the ratio is less than one (inelastic), tax revenue grows more slowly than the economy and the public sector becomes relatively smaller.

that the responsiveness to economic growth should be near unity (the public and private sectors should grow about equally in percentage terms). The two concepts are generally positively related.

Equity is an even more complex concept. Equity can be viewed from the standpoint of the taxpayer, the administrator and the economist. From a practical standpoint a tax system is equitable if the taxpayers believe they are being treated fairly. From the administrators' viewpoint a tax system is equitable if it yields sufficient revenues to support expenditure needs (adequately), if it is economical to administer (simplicity) and if taxpayer complaints are at a minimum. While these two views are perhaps equally as significant as a third one, economists are generally concerned with the third.

In textbook terms, equity is defined as treating taxpayers in equal circumstances equally (horizontal equity) and taxpayers in unequal circumstances unequally in relation to their inequalities (vertical equity). This suggests that we can determine the incidence of each tax in the system.[6] It also raises the question of how to measure equality and inequality at the point of incidence. Should the measure be income, wealth, expenditures or a combination of factors? And how should we define these factors? The most common measure used is income. Once incidence is established for all taxes, once it is known who actually bears the burden of every tax dollar, we can relate it to a broad measure of taxpayer income. Income, then, is the measure of tax capacity and

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6. Incidence is defined as the point of burden of a tax after it is shifted as much as possible from the point of impact. For example, taxes impacting on business can be shifted to the consumer in higher prices or to the factors of production in lower wages, rents, interest or profits.

burden can be related to capacity by income class. Establishing tax incidence is necessary in order to determine whether a tax system is progressive, proportional or regressive.[7]

Tax impact is also significant in discussing tax equity. Tax neutrality is not always the accepted goal of taxation[8] and tax impact can influence economic decisions in the private sector. Tax impact can be discussed in terms of balance.

(1) Taxes must be balanced between business and individuals. Only families and individuals have the capacity to pay taxes. Business taxes are finally borne by business owners, the consumers or the employees and suppliers of other business inputs. Business taxes can influence relative prices, wages and profits and, thereby, business location decisions.

(2) Taxes must be balanced between the state and its subdivisions. The allocation of financing responsibilities should conceivably be determined by the allocation of administrative responsibilities. However, in many cases, the state has a definite interest in local programs (e.g., education) and should share the financing responsibilities. Most taxes can be collected more efficiently at the state than at the local level. Finally there are poor jurisdictions that are unable to finance their responsibilities in the absence of an unduly high tax effort. Tax sharing is the proper answer.

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7. A tax or a tax system is progressive if the percentage of income paid in taxes increases as income increases; it is proportional if the percentage remains constant at all levels of income; it is regressive if the percentage declines as income increases.

8. Neutrality in taxation implies that taxation is used in a way that leaves the allocation of economic resources unaffected by the taxes, that economic decisions can be made on grounds of economic efficiency and not on tax grounds.

(3) Business taxes must be properly balanced among industries. The commercial, financial, manufacturing, etc., sectors must present balanced growth as determined by the state's resources. If taxes are biased against any industry, economic resources will be misallocated and economic development impeded. Employment and income suffer. The preferred system of business taxation is one which considers the government a factor of production and charges business firms in relation to the costs of public services consumed (the benefits principle). By this method, taxes are neutral as to the allocation of economic resources.

(4) Taxes must be properly balanced among personal taxpayers. This has reference to both the impact and the incidence of the taxes. The distribution may be progressive, proportional or regressive. If we accept that state and local governments are service-oriented and that all taxpayers benefit equally from government according to their income, then an equal percentage of every income should be paid in taxes. (The incidence is proportional to income).

(5) Taxes should be properly balanced among the major tax sources--expenditures, income and wealth. This helps to ensure that all taxpayers pay a reasonable share of the taxes. Some are rich in property but poor in expenditures and income. Others are rich in income but spend little and own little property. The choice of tax sources also has a decided effect on tax incidence and other equity factors.

Tax efficiency means that the tax system is as neutral as possible

in regard to the private sector allocation of economic resources.[9] Neutrality has already been referred to. The neutrality concept is often violated where specific incentives are desired to achieve selected economic or social goals, but in the main the individual's decisions as to the use of economic resources should be independent of tax considerations. Private sector decisions made strictly on economic considerations promote optimum economic development (and employment and income). Attempts at state intervention must be carefully conceived and executed. Often the long-run effects are directly opposed to what is desired and expected.

Tax simplicity implies that taxes are relatively economical in regard to administration and compliance. They are simple enough to be easily understood. Record keeping is kept at a minimum. "Nuisance" taxes, low in revenue, but expensive in administration and compliance, are kept to a minimum. Simplicity not only means that the law is easy to comply with, but that enforcement (auditing of taxpayer returns, etc.) is economical.

These criteria of adequacy, equity, efficiency and simplicity sometimes conflict. From this conflict stem many of the disagreements about the optimum tax system. Moreover, these objectives must be balanced with taxpayer acceptability and political feasibility. Understanding

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9. Tax efficiency can also be discussed in terms of the "excess burden" taxes generate. Efficiency is inversely related to the amount of excess burden created. If the change in consumption patterns due to a set of taxes results in a loss in community welfare, then the tax system has created an excess burden on the community. The more responsive the demand for a private good is to a price change, the more the excess burden by taxing it. The more responsive a public good is to a price change, the more the excess burden of taxation is offset. One goal of tax policy is to minimize the excess burden.

the basic terms gives an overall philosophical framework within which to make practical decisions. Once they are understood and the current tax system evaluated accordingly, progress can be made toward establishing a revised tax system if the current system fails to meet the established criteria.

The current state[illegible]cal tax system is evaluated in Chapters IV and V and proposals for [illegible]s are presented in Chapter VI.

Prior to the ev[illegible]ons in Chapters IV and V, however, the discussion in Chapter III outlines the basic principles of a state-local fiscal transfer system. It is designed to help the tax system achieve the four goals of taxation outlined above. Taxation is the first and basic line of attack; but it alone is incapable of achieving the goals in a society in which public responsibilities are fractionalized among two levels of government and many local units.

In the second approach, the gain in welfare (utility) of a resource employed in the public sector can be compared with the loss in welfare (disutility) as the unit is withdrawn from the private sector (taxes). If there is a net gain in welfare by the transfer (utility gain due to the increase in public services is greater than disutility due to the decrease in the private sector activity), total welfare is enhanced. If there is a reduction in public welfare by the transfer of a resource unit at the margin, there is a reduction in total welfare. When the optimum intersectoral allocation is reached, total welfare will be reduced by a shift of economic resources either from or to the public sector.

CHAPTER III

EQUALIZING THE BENEFITS AND BURDENS OF GOVERNMENT THROUGH FISCAL TRANSFERS

Introduction

The purpose of this chapter is to discuss the role of fiscal transfers as a secondary tool for equalizing jurisdictional and individual public benefits and burdens.[1] It is generally accepted that citizen well-being is maximized in a federal organization in which some public programs are administered by the state and others by local jurisdictions.[2] The choice of which public functions get decentralized is determined by a combination of economic, political and social forces. While economic forces in many cases justify centralization (economic efficiency), political and social considerations often are more important in the decision-making process. Excessive administrative decentralization may not optimize administrative efficiency; but public well-being may be maximized because the administration is close to the people involved and is more intimately controlled by them.[3]

Decentralization of administration for a large number of functions is rational in a federal system, but it creates financing problems that

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1. As noted in Chapter II, the primary tool is the tax system.

2. In this report, the discussion is involved with equalization within the state. Federal efforts to equalize both interstate and intrastate, while significant, are not involved.

3. That is, the citizens are more able to select a package of public services and service levels more suitable to local conditions and local preferences than if services and service levels are mandated uniformly over large geographic areas and heterogeneous populations.

can be solved only by a carefully conceived state-local tax and fiscal transfer system.

The Problems

(1) The public benefits provided and costs incurred by a local jurisdiction in meeting its administrative obligations often cannot be confined within the political boundaries. This is commonly referred to as benefit and cost "spillovers" or "non-correspondence" of benefits and costs within the political boundaries.

(2) Local administrative areas are not generally large enough to be efficient revenue collection jurisdictions. This is especially true for nonproperty taxes.

(3) Many local jurisdictions do not have sufficient taxable resources or tax bases (property, income, etc.) to support functions for which they are administratively responsible without excessive tax rates. Others can meet their expenditure obligations with average or below average tax rates because of their ample supply of taxable resources. This phenomenon is commonly referred to as "fiscal disparities." A closely related term is "fiscal imbalance," which implies that there is a noncorrespondence of tax authority and administrative responsibilities between the state and the local governments.

(4) The fourth and final problem involves inequitable individual tax burdens that are found in every local jurisdiction because of individual differences in tax capacity. This may be

classified as individual "fiscal disparities" in contrast to the jurisdictional "fiscal disparities" mentioned at (3).

When benefit levels are assumed to be a function of financing levels, it is evident that the financing problems created by decentralization often result in a situation in which benefit levels are unequal, jurisdictional tax efforts and individual burdens are unequal, or both. With the advent of interest in tax equity and intrastate uniformity of access to public services (especially education), the correction of fiscal imbalances and noncorrespondence takes on added significance.

The Allocation of Administrative Responsibilities

Oates[4] defines the economic objectives of government as follows:

> The functions of the public sector are to ensure an efficient use of resources, to establish an equitable distribution of income, and to maintain an economy at high levels of employment with reasonable price stability.

Musgrave,[5] in defining the three objectives of budget policy, provides for a system by which public functions can be assigned on a rational basis to the various levels of government. First, he lists two broad categories of public functions that, for reasons of efficiency and equity, require federal administration and financing. They are income and wealth distribution and the twin goals of price stabilization and full employment. States and local jurisdictions are unable to deal

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4. Wallace E. Oates, Fiscal Federalism (New York: Harcourt, Brace, Jovanovich, Inc., 1972), p. 3.

5. Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), p. 5.

effectively with these objectives because of their limited jurisdictional reach. Moreover, uniformity of service levels is expected. Oates states it as follows:

> One would...expect a central government to provide a better approximation of the efficient level of output to those public goods that benefit the members of all communities than would a system of decentralized decision-making.[6]

Second, Musgrave includes as a third category of public functions a list of resource allocative (service) functions, some of which may be administered efficiently at the state or local level. Oates explains it as follows:

> A decentralized form of government...offers promise of increased economic efficiency by providing a range of outputs of certain public goods that corresponds more closely to the differing tastes of groups of consumers.[7]

In summary, the federal government should administer functions for which nationwide uniformity of service levels and financing are desirable. States should administer functions for which individual output levels can vary within tolerable limits from state to state with only inconsequential effects on national objectives. Similarly states can further assign functions to local governments allowing community service levels to vary with only inconsequential effects on state or national objectives. This provides the citizens with the broadest scope possible for selecting jurisdictional service levels. However, as noted elsewhere, the lines of demarcation are blurred by benefit spillovers.

Allocation of Financing Responsibilities

The federal system is a multilevel system in which both the financing and administrative responsibilities are allocated among the different

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6. Oates, op. cit., p. 10.

7. Oates, op. cit., p. 12.

layers of government. This dispersion of responsibility often results in the failure to place fiscal resources at the point of administrative responsibility.

The purpose of allocating administrative responsibilities is to provide equal access to public services for all citizens, yet permit tolerable variations in service levels for distinctly local services.[8] Public funds should be allocated so as to ensure that each community and each taxpayer can share equally in public service opportunities at reasonably uniform burdens to the taxpayers.

Financing responsibility should be allocated to the various levels of government in proportion to the demographic or geographic need for uniformity of service levels. That is, where the benefits of government services accrue generally to all citizens, equitable financing on a nationwide basis is required. Where the benefits of government services accrue primarily and uniformly to residents of states and where national objectives are not foremost, equitable financing on a state basis is required. Where the benefits accrue primarily to local area residents and state and national interests are not foremost, equitable local financing is required (supplementation by state contributions should be used to balance revenues with needs for low-ability jurisdiction). Where benefits accrue to citizens in their capacity jointly as local,

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8. When these variations are slight, they result in tolerable differences in the quality and quantity of local public service and burden levels. When the differences are limited to the local community, national and state interests are unaffected. Significant differences among communities in expenditure needs and fiscal abilities may cause poorer areas to have inadequate services even with high tax burdens.

state and national citizens, the financing responsiblities should be shared proportionally among the various levels of government according to the distribution of benefits (weighted by the jurisdictional abilities of the various governments to contribute their proportionate share).

In order to coordinate financial resources with public needs, financial responsibility should be allocated without regard to the point of tax imposition. However, the tax system should be the primary tool for coordinating needs with resources. A secondary but equally necessary tool for equalizing the interjurisdictional tax efforts and individual tax burdens is governmental fiscal transfers.

The Case for Intergovernmental Fiscal Transfers (State Aids and Shared Taxes)

State and local jurisdictional lines were drawn a good many years ago in a frontier society. Under the existing economic and social conditions, there was general widespread coincidence of efficiency in administration and revenue-raising areas and limited concern for differences in the scope of public programs on jurisdictional tax ability and effort. There was little demand for intergovernmental fiscal coordination and tax or benefit equalization. Each community and the state determined its needs and financed them largely independent of the others.

Because of the growth in economic and social interdependence, tax policy alone has proven insufficient to satisfy the growing demands for statewide equity in tax efforts and burdens and in benefits from public services. Tax equalization policies must be supplemented with intergovernmental fiscal transfers so that adequate public funds are coincident with administrative responsibilities.

Externalities and State Fiscal Transfers

One of the basic arguments for state fiscal transfers to local jurisdictions is the increasing interdependence of modern society. Economic development, especially in communication and transportation, contributes to interjurisdictional resource mobility and serves to expand the geographic boundaries for public services. For many locally-administered public services, therefore, the beneficiaries are to a significant extent nonresidents. No amount of realignment of political boundaries or of realignment of functional administrative responsibilities (short of complete centralization) can relegate all benefits and costs of major programs within a single local jurisdiction. For locally-administered programs in such areas as public education, welfare and transportation, widespread benefits accrue, not only to local residents but also to residents of the state.

For public programs characterized by significant "spillover" effects, special purpose fiscal transfers are necessary to compensate for the possible inefficiencies arising from the decentralization of administration.[9] Where the "spillovers" are largely contained within the state, the state is the logical source of fiscal assistance. (Where the "spillovers" extend to multistate areas, the federal government should also contribute to the financing.)

Typically, the financing should be shared proportionally by formula allocation, each level of government contributing according to its degree of interest or need (but not necessarily ability). This, in

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9. Unless all levels of government from which citizens receive benefits from a locally-administered public service contribute to its costs, the presumption is that it may be underfinanced because the local decision-makers ignore the "spillover" benefits when financing the programs. See Oates, op. cit., pp. 66-73.

effect, amounts to a matching grant in which the recipient government is required to match the dollars it receives with dollars raised locally (but not dollar for dollar since the degree of "spillover" may vary). Moreover, the grants should be open-ended[10] so that the optimum efficient level of services is provided in every jurisdiction in the state and thereby in the entire state. As Oates states it, "... the appropriate form of intergovernmental grant to correct for interjurisdictional externalities is an open-end, matching grant...."[11]

In summary, a few select governmental functions, commonly locally-administered, are of such significant statewide impact that partial state financing in the form of conditional grants is essential. The grants should be allocated by formula and be financed by an open-ended state appropriation.

Fiscal Imbalance, Fiscal Disparities and State Fiscal Transfers

Fiscal imbalances develop between the levels of government when one level (usually the state) possesses the ability and authority to raise revenue in excess of its expenditure obligation and the other (the local) level is in the opposite situation. A variety of factors contribute to the possible growth of imbalances. First, they are generated by the rapid growth of local public obligations as a result of social and economic development. Second, the federal and state governments often mandate additional local obligations for which no permanent compensatory revenue authority is granted. Finally, state tax sources are usually a little more responsive to economic growth than are local sources.

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10. Oates, op. cit., p. 75.

11. Oates, op. cit., p. 75.

Fiscal disparities arise between governments on the same level because of the differences among them in the ability to raise revenue and in their expenditure needs. Great variations in interjurisdictional fiscal abilities and efforts stand out in the state. These large differences may cause poor jurisdictions to have inadequate services even with high tax rates. This discourages further economic development and tends to increase and perpetuate fiscal disparities since these areas tend to be deficient in public service levels.

Both imbalances and disparities must be corrected to achieve an equitable tax system. The vertical imbalances (state-local) can be largely corrected by a redistribution of the taxing authority or a series of intergovernmental transfers that match resources by government level with expenditure obligations. The horizontal disparities problem can be settled by grants that have an interjurisdictional equalizing effect. Both redistribution (vertical) and equalization (horizontal) can be incorporated in the same grants.

Interjurisdictional equalization of tax efforts involves removal of the disparities in the abilities of local jurisdictions to finance adequately and uniformly the public functions for which they have administrative responsibility. The spreading expanse of economic and social interdependence and the growing concern for equity in the access to public services at substantially equal cost burdens have led to demands for increased emphasis on equalization grants.[12]

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12. The most outstanding example is the drive for equality in education financing and equal access to public education. In this instance, benefit "spillovers" are especially large; they increase as population mobility increases. Many current state aid-to-education programs are only mildly equalizing and do little to remove interjurisdictional burden disparities. It makes little difference whether the local share is raised by property or nonproperty taxes. Similar interjurisdictional ability disparities are found in the bases of expenditure and income taxes as are found in property taxes.

Summary

Considerable dependence for achieving interjurisdictional tax equity must be placed on the second line of defense (state fiscal transfers) because of the inability of local governments to efficiently employ a broad series of equitable taxes and because of their different abilities to collect revenues. State conditional grants can equalize financing for public services as well as remove "spillovers." This is especially true on occasions in which the distribution formulas contain both "effort" and "needs" factors.

Individual conditional grants are impractical for a host of basically local programs. In addition to the major public programs for which conditional grants are appropriate, other less costly general government programs, usually local in impact, are of sufficient economic and social importance to be included in a general equalizing grant. General grant programs should be designed to equalize public services at a level below which no jurisdiction should be permitted to fall. Each jurisdiction should be required to contribute to this minimum adequate level of services in relation to the level of its taxable resources (ability-to-pay). No poor jurisdiction should be required to levy excessively high taxes in order to support a basic level of services. Nor should any wealthy jurisdiction be permitted to secure excessive state assistance and escape with low average tax burdens.

This suggests a minimum foundation type of approach for financing local functions such as police and fire protection and local general government. The proper tool would be a matching, open-end, general state grant. It would be distributed to the local jurisdictions by a formula containing a strong requirement for minimum local effort based

on the level of community taxable resources. Thus, jurisdictions with limited taxable resources receive relatively more state fiscal assistance than do their wealthier neighbors.[13] Preferably, state assistance would fill the financial gap between the local effort and a basic level of local public services. Jurisdictions should then be given leeway to provide a level of services beyond the minimum adequate level but at full local cost. Unless this is permitted, the desires of the local citizens will be aborted and economic and social efficiency will be decreased.

Individual Fiscal Disparities and State Fiscal Transfers

Just as interjurisdictional tax equity requires equalizing revenue grants to local governments, individual tax equity requires that state financial assistance be offered to disadvantaged individuals. Not all taxpayers in the state are equally endowed with taxable resources. Not all are equally able to bear average tax burdens.

As long as state-local tax systems continue to place significant emphasis on broad consumption and property taxes, tax burdens will be relatively high on taxpayers at the lower end of the income and wealth scale and decline as income and wealth increase. Despite all

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13. By combining special purpose and general purpose grants, the effects of what is commonly called "municipal overburden" can be overcome. "Municipal overburden" is a term that applies to a jurisdiction with above-average needs in the area of general government and little capacity left to support major functions such as public education. Having removed the overburden for a number of services, a jurisdiction is then able to raise its share of public education revenues without seriously overburdening the taxpayers.

reasonable efforts leading to tax reform and jurisdictional equity some form of individual tax relief to taxpayers on the lower end of the scale is necessary if proportionality in taxation is to be achieved.[14]

The most practical relief in current use in the states is in the form of tax credits or refunds for property and general sales tax,[15] neither of which can be assumed to be based on ability-to-pay. The credits or refunds are generally restricted to a select group of taxpayers (aged, disabled, etc.) and refunds are based on the relationship of income to tax liability. Equity, of course, requires that the relief be granted equally to all taxpayers. The amount of credit or refund generally declines as income rises so that relief is available only to low-income taxpayers for which tax burdens are considered to be excessive and regressive. The cost of a tax equalization program for individual taxpayers is determined by the level of taxation and by the degree of regressivity in the state-local tax system.

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14. While individual tax incidence in proportion to income is not necessarily the only distribution that could be sought, it seems to be a reasonable goal in the light of the purposes of state and local governments.

15. General relief in the form of property tax homestead exemptions and exemptions of sales of food, etc., from the general sales taxes are more politically popular. They do not significantly reduce income regressivity and revenue loss from their use is great. Advantages and disadvantages of various relief techniques are discussed in Chapter V. The tax credit referred to is a credit against another tax liability. For example, property or sales tax relief can be credited against the individual income tax in some states. If no other tax liability is present, a refund may be granted.

Property and general sales taxes are no more regressive and in need of redress than are many public charges and fees and selective sales taxes. Because adequate general relief programs for these fees and taxes are difficult to achieve, adequate relief from the two basic taxes can remove most of the regression from the state-local tax system.

The most popular form of selective property tax relief is the "circuit breaker." While it is generally a part of the income tax process, several states administer it separately. In general, tax relief is triggered when the residential property tax becomes "excessive" in relation to household income. Relief may be granted in the form of a direct credit against the property tax bill, a credit against an income tax liability or a direct refund. Twenty-four states and the District of Columbia now use the "circuit breaker" for some low and moderate income taxpayers. The provisions also apply to renters in some states. A portion of annual rent paid is assumed in some state programs to be an indirect homestead property tax.[16]

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16. For a good explanation of the "circuit breaker" property tax relief, see Advisory Commission on Intergovernmental Relations, Property Tax Circuit Breakers: Current Status and Policy Issues, Report M87, February 1975, and the Appendix to this chapter.

CHAPTER IV

TENNESSEE'S ECONOMY AND ITS STATE-LOCAL TAX SYSTEM

> When more of the people's sustenance is exacted through the form of taxation than is necessary to meet the just obligations of Government and expenses of its economical administration, such exaction becomes ruthless extortion and a violation of the fundamental principles of a free government.
>
> Grover Cleveland
> Second Annual Message
> December 1886

Introduction

The first step of any evaluation of the fiscal structure of a state or local government is to inventory and assess the economic base from which government revenues are exacted and to evaluate the equity and efficiency of the taxing system. With this information at hand the analyst is equipped to compare the types, distribution and benefits of the legislated expenditure programs of both state and local governments.

The tax base of any taxing jurisdiction is shaped and influenced by the kind and level of economic activities which take place. Although it is generally recognized that state and local economies reflect national conditions, each state and local government possesses certain economic characteristics which greatly determine the types of taxes used, the growth of the revenues and the overall equity of the system.

When it comes to the evaluation of a tax structure, there are no absolutes. We aim for a comparison among regions, states and local governments utilizing certain accepted evaluation measures, e.g., per capita tax burden, taxes paid according to income bracket and tax structure mix. In this chapter three topics will be analyzed: the tax base,

the tax and revenue mix and the overall tax burden on the Tennessee taxpayer. Each subject will be evaluated from the point of view of how Tennessee compares with states in the southeastern region and other regions.

The Tax Base

The levels of personal income and business activity in a state or within the jurisdictional region of a local government determine the size of the tax base. The types of business activity affect the stability and responsiveness of tax revenues to economic growth and fluctuations.

All types of production are not equally affected by national economic fluctuations nor do they all grow at equal rates. A taxing jurisdiction, whether it be a state or local government, is better off if its tax base is comprised of various kinds of businesses so that the downturn of some will be offset by either the upturn or, at least, the stability of others.

In the case of Tennessee, the Gross State Product (GSP), which is a measure of the market value of all productive activity that takes place within the state's borders, increased from 1968 to 1977 at an average annual rate of 4.4 percent in constant 1972 dollars. This is compared with a rate of increase in the Gross National Product (GNP) of 2.9 percent for the same period (Table 4-1). The increase in GSP was reflected by an accompanying increase in per capita income of 3.4 percent in Tennessee over the same period. The U.S. comparable income growth was 2.6 percent. The real per capita income (in 1972 dollars) in Tennessee in 1967 was $3,001 compared to a national figure of $4,204; in 1977 the figures were $4,204 and $5,036 respectively. Thus, in the ten year span, Tennessee per capita real income went from 77 percent to 83 percent

TABLE 4-1

ANNUAL RATE OF GROWTH IN CONSTANT 1972 DOLLARS

	Average 1968-1977	1970	Average 1971-1973	1974	1975	Average 1976-1977
U.S. Gross National Product	2.9	-0.3	4.7	-1.4	- 1.3	5.5
Tennessee Gross State Product	4.4	1.1	8.5	-1.0	- 4.7	6.9
Manufacturing	4.8	1.3	9.7	-3.2	-12.5	9.9
Durable Goods	4.9	-0.8	10.4	-1.3	-20.6	12.7
Nondurable Goods	4.7	3.0	9.2	-4.6	- 6.1	7.9
Construction	3.5	-5.1	12.8	-1.1	- 8.3	4.6
Mining	3.0	4.5	8.2	8.0	- 3.8	-4.9
Trade	4.9	-0.4	9.8	-1.1	1.6	6.6
Services	4.4	4.5	7.2	-0.4	0.7	5.1
Finance, Insurance and Real Estate	4.5	0.7	8.5	0.7	- 1.4	5.2
Transportation, Communications and Public Utilities	5.6	2.2	10.7	2.0	- 1.9	5.8
Government	2.7	-0.3	3.5	3.9	3.9	2.3
Federal	1.2	-1.7	-0.3	4.1	5.9	3.5
State and Local	3.7	0.7	5.8	3.7	2.8	1.7
Agriculture	1.7	6.9	-3.3	-8.2	- 3.1	15.4

SOURCE: Tennessee Econometric Model, Historical Data and December 1, 1977.

of the national average. Table 4-2 provides a detailed breakdown of the growth of wage and salary real income in Tennessee by sector.[1]

Any improvement in real or nominal per capita income is an indication that industrial, service and agricultural output is increasing in such a way that the increase in population is more than offset. However, this growth in output did not occur proportionately in all segments of the state economy. As shown in Table 4-3, the mix of production shifted slightly. There was a 13 percent growth in transportation, communications, and public utilities; and a 7 percent increase in the trade sector. All this gain was offset by a 13 percent decrease in government and minimal decreases in manufacturing, construction and agriculture.

When compared to the national product mix, Tennessee is much more dependent upon manufacturing than the average state. Of more significance is the large proportion of GSP devoted to nondurable goods production. Since the production of durable goods is more sensitive to economic fluctuations than nondurable goods, the expected effect is that Tennessee would be less sensitive to short-term national downturns. However, over a prolonged period, the demand for nondurable goods is also affected by a national recession and the Tennessee economy would react quite strongly. These expectations are substantiated by the rates of growth presented in Table 4-1. What this means for Tennessee is that the tax base has been growing over the past decade with minor slippage when the national economy experienced prolonged contractions. The outlook for the future is for real growth rates through 1979 between 4.5 and 5.5 percent, with

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1. William C. Goolsby, et. al., An Economic Report to the Governor on the State of Tennessee (Nashville: Tennessee State Planning Office, prepared by the Center for Business and Economic Research, College of Business Administration, The University of Tennessee, Knoxville), January 1978, p. 23.

TABLE 4-2

GROWTH OF WAGE AND SALARY AND PER CAPITA INCOME
IN CONSTANT 1972 DOLLARS

	Average Wage and Salary		Average Annual Growth Rate
	1968	1977	1968-1977
All Sectors	6,406	7,119	1.4
Manufacturing	6,754	7,625	1.6
Durable Goods	6,829	7,806	1.6
Furniture and Fixtures	5,771	5,953	1.4
Fabricated Metals	7,006	8,286	1.6
Nonelectrical Machinery	8,511	8,668	0.5
Electrical Machinery	6,513	7,203	1.5
Transportation Equipment	7,495	7,991	0.8
Other	6,753	8,076	2.0
Nondurable Goods	6,700	7,486	1.5
Food	7,196	8,139	1.7
Textiles	5,738	5,919	1.0
Apparel	4,342	4,672	1.4
Paper	8,226	9,432	1.4
Chemicals	9,356	11,083	0.8
Rubber and Plastics	9,106	9,395	0.8
Other	6,033	6,400	1.1
Construction	7,253	8,046	1.5
Mining	7,087	8,672	2.2
Trade	5,688	6,012	0.7
Services	5,970	6,170	0.7
Finance, Insurance and Real Estate	6,876	7,568	1.5
Transportation, Communications and Public Utilities	8,349	10,288	2.4
Government	6,626	7,488	1.5
Federal, Civilian	9,115	11,400	2.2
State and Local	5,915	6,367	1.1
Agriculture	1,296	2,220	5.7
Per Capita Income (Tennessee)	3,100	4,204	3.4
Per Capita Income (U.S.)	4,035	5,036	2.6

SOURCE: Tennessee Econometric Model, Historical Data and December 1, 1977.

TABLE 4-3

PERCENTAGE DISTRIBUTION OF GROSS STATE PRODUCT
AND GROSS NATIONAL PRODUCT, 1968 AND 1977

	Gross State Product		Gross National Product	
	1968	1977	1968	1977
Total	100.0	100.0	100.0	100.0
Manufacturing	36.1	35.9	25.5	24.1
Durable Goods	15.3	15.3	15.7	14.6
Nondurable Goods	20.7	20.7	9.8	9.5
Construction	4.3	4.1	5.9	4.4
Mining	0.6	0.5	1.7	1.5
Trade	16.2	17.3	16.2	16.8
Services	10.3	10.3	11.1	12.3
Finance, Insurance and Real Estate	11.2	11.5	13.7	15.6
Transportation, Communications and Public Utilities	6.7	7.6	8.4	9.0
Government	11.8	10.4	14.1	12.3
Federal	4.8	3.8	--	--
State and Local	7.0	6.6	--	--
Agriculture	2.9	2.3	3.1	3.2

Note: Detail may not add to total because of independent rounding.

SOURCE: Tennessee Econometric Model, Historical Data and December 1, 1977.

the lower rates occurring in the later years.

To get some idea of how Tennessee's growth compared with 13 other states in the southeastern region, annual rates of change of per capita income were calculated on the basis of current and 1972 dollars and presented in Table 4-4. Although per capita income is only one index of economic growth, it does give some indication of the growth in the potential tax base. Between 1967 and 1976 Tennessee had an annual rate of real growth (3.8 percent), which was greater than five of the other states and the same as North Carolina. However, because the rate of growth in current dollars was so rapid in the region, all states exceeded the national rate. These comparisons are made with the full recognition that price changes and hence the factor used to deflate current income would not necessarily be the same in each state as they were assumed to be in these calculations.

Trends in State-Local Tax Collections

From the information presented in the previous section, it is evident that Tennessee's tax base has grown significantly over the past decade. In addition it has exhibited a reasonable degree of stability in terms of immunity from short-term national economic fluctuations. However, over the same period, how have state and local governments reacted towards this growing source of potential revenue? Specifically, what has been the trend of total tax collections; has the tax mix changed; what has happened to the distribution of tax burden on individuals and businesses; and has the state been fully utilizing its potential revenue?

Tax Collections

The Tennessee tax base, as measured by total personal income, has increased from 1961 to 1976 by 390 percent (Table 4-5). This is about

TABLE 4-4

PER CAPITA INCOME, SOUTHEASTERN STATES, 1967 AND 1976,
ANNUAL RATE IN CURRENT AND 1972 DOLLARS

State	1967		1976		Annual Rate of Change	
	Current Dollars	1972 Dollars	Current Dollars	1972 Dollars	Current Dollars	1972 Dollars
Alabama	$2,163	$2,711	$5,016	$3,771	14.7	4.3
Arkansas	2,099	2,630	4,935	3,711	15.0	4.6
Florida	2,853	3,575	6,019	4,526	12.3	3.0
Georgia	2,541	3,184	5,548	4,171	13.1	3.4
Kentucky	2,426	3,040	5,379	4,044	13.5	3.7
Louisiana	2,456	3,077	5,405	4,064	13.3	3.6
Maryland	3,421	4,287	6,881	5,174	11.2	2.3
Mississippi	1,896	2,376	4,530	3,406	15.4	4.8
North Carolina	2,439	3,056	5,453	4,100	13.7	3.8
South Carolina	2,213	2,773	5,148	3,871	14.7	4.4
Tennessee	2,395	3,001	5,364	4,033	13.8	3.8
Texas	2,744	3,439	6,201	4,662	14.0	4.0
Virginia	2,804	3,514	6,341	4,768	14.0	4.0
West Virginia	2,334	2,925	5,459	4,105	14.9	4.5
U.S.	3,153	3,951	5,511	4,137	8.3	.5

SOURCE: U.S. Department of Commerce, Bureau of the Census, State Government Finance (selected years).

TABLE 4-5

STATE AND LOCAL TOTAL PERSONAL INCOME, SELECTED YEARS
1961 TO 1976, BY STATE, CURRENT DOLLARS
(Dollar Amount in Millions)

	1976		1974		1972		1970		1967		1961	
State	Amount	Index	Amount	Index	Amount	Index	Amount	Index	Amount	Index	Amount	Index
Alabama	$ 18,714	380	$ 15,313	311	$ 12,237	248	$ 9,832	199	$ 7,656	155	$ 4,926	100
Arkansas	10,408	401	9,504	348	6,717	259	5,376	207	4,310	159	2,598	100
Florida	50,690	494	43,742	426	32,694	319	24,938	243	17,101	167	10,263	100
Georgia	27,576	420	22,396	341	18,724	285	15,345	233	11,458	174	6,573	100
Kentucky	18,439	369	15,314	306	12,014	240	9,901	198	7,737	155	4,998	100
Louisiana	20,762	384	16,766	310	13,326	247	11,130	206	8,995	167	5,400	100
Maryland	28,514	362	24,425	310	20,307	260	16,789	213	12,595	160	7,880	100
Mississippi	10,663	392	8,955	329	7,192	264	5,706	210	4,453	164	2,722	100
North Carolina	29,821	394	24,990	330	20,193	267	16,331	216	12,267	162	7,576	100
South Carolina	14,662	425	12,181	353	9,408	273	7,616	221	5,752	167	3,450	100
Tennessee	22,606	390	18,949	327	15,101	260	12,128	209	9,316	161	5,803	100
Texas	77,436	397	61,362	315	47,404	243	39,671	203	29,822	153	19,503	100
Virginia	31,908	412	26,399	341	20,947	271	16,827	217	12,719	164	7,743	100
West Virginia	9,941	318	7,994	256	6,504	208	5,259	168	4,197	134	3,126	100
Total	$372,140	402	$308,608	334	$242,768	262	$196,849	213	$138,198	149	$92,561	100

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, Number 8 of selected years.

average for the 14 states considered in the southeastern region. When compared to the total tax collections of state and local government in each state, Tennessee governments collected 444 percent more in 1976 than they did in 1961 (Table 4-6). Since most state and local tax revenues do not increase proportionately with income, the explanation of the faster increase in collections is that the tax rates of several taxes were increased during this 15 year period. This is clearly the experience in Tennessee where the state sales and local property tax rates were increased several times.

Tennessee Tax Structure[2]

The concepts of equity and neutrality are useful in evaluating any state-local tax structure. Besides having revenue-generating potential, a tax structure should be designed so that certain absolute and relative standards of equity and neutrality are met. The dual objectives of revenue generation and the two qualitative characteristics are frequently difficult to reach with each tax. Therefore the more realistic approach is to consider the objectives from the point of view of the entire tax structure. The deficiencies of some taxes can be offset by the more favorable features of others. As long as effort is made to make each tax as equitable and neutral as possible, the overall structure will compare favorably with generally accepted standards. Sometimes the use of certain taxes which are nonneutral or inequitable cannot be avoided.

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2. This section is based upon similar research done for an article entitled "The Neutrality and Equity of the Tennessee Tax Structure," Arthur A. Bayer, to be published in Mid-South Review, Memphis State University, March 1978.

TABLE 4-6

STATE AND LOCAL TAX COLLECTIONS, SREB STATES, SELECTED YEARS,
1961 TO 1976 BY STATE, CURRENT DOLLARS
(Dollar Amounts in Thousands)

State	1976		1974		1972		1970		1967		1961	
	Amount	Index	Amount	Index	Amount	Index	Amount	Index	Amount	Index	Amount	Index
Alabama	$ 1,718,596	417	$ 1,419,505	345	$ 1,140,264	277	$ 927,476	225	$ 685,800	167	$ 411,873	100
Arkansas	972,363	410	805,319	340	630,500	266	492,100	208	394,200	166	237,100	100
Florida	4,871,407	492	4,326,702	437	3,297,737	333	2,461,600	249	1,685,600	168	989,400	100
Georgia	2,762,907	464	2,359,222	396	1,882,535	316	1,476,900	248	1,030,200	173	595,200	100
Kentucky	1,893,335	425	1,494,330	336	1,178,936	265	979,500	220	689,600	155	445,003	100
Louisiana	2,364,276	378	1,891,121	303	1,594,016	255	1,232,900	197	955,300	153	625,100	100
Maryland	3,374,204	519	2,773,855	427	2,225,813	343	1,895,600	292	1,202,800	185	649,800	100
Mississippi	1,165,479	399	1,010,597	346	795,481	273	674,054	231	462,200	158	291,900	100
North Carolina	2,944,351	441	2,536,033	380	2,012,969	302	1,667,688	250	1,141,600	272	666,917	100
South Carolina	1,424,584	450	1,200,740	379	925,041	292	730,200	231	522,200	165	316,600	100
Tennessee	2,188,215	444	1,857,604	377	1,511,650	307	1,178,900	239	822,500	167	492,600	100
Texas	7,433,272	463	5,814,823	362	4,661,860	290	3,710,500	231	2,488,300	155	1,606,300	100
Virginia	3,137,124	520	2,575,243	427	2,055,202	341	1,640,184	272	1,109,600	184	603,386	100
West Virginia	1,078,930	378	825,361	289	713,748	250	539,870	189	412,300	144	285,489	100
Total	$37,329,046	454	$30,690,408	376	$24,625,696	300	$19,607,440	239	$13,575,200	165	$8,216,668	100

SOURCE: U.S. Department of Commerce, Governmental Finances, selected years.

In these cases a state or local government should attempt to minimize the proportion of total revenues raised by these taxes.

The various sources of revenue for both state and local governments in selected states are presented in Table 4-7. Each percentage represents the proportion of total state and local revenue raised by the specified tax. For comparison purposes, percentages are listed for the average of all states in the United States, the twelve southeastern (SE) region states and the arithmetical mean is listed for the SE region states.

It is evident that Tennessee relies more heavily upon the sales tax than the average of other states in the United States, but is not significantly different from the average of the SE states. The income tax percentages clearly underscore the different tax structure used in Tennessee. By not having a broad-based, personal income tax, Tennessee raises a much smaller percentage of its revenues from this source than the average for the nation and other SE states. However, Tennessee generates a larger percentage of its total revenues from the corporation income tax than the average of all other states and the average of other states in the SE region.

It is interesting to note that, in general, local governments in the SE region raise a smaller percentage of the total state-local revenue (36.8 percent) than the average of all local governments in the United States (46.6 percent). The difference is most significant for revenues from property taxation. Although local governments in Tennessee generate a proportion of total revenue equal to the national average, the lower property tax revenues are offset by the greater use of other taxes and miscellaneous charges.

TABLE 4-7

STATE AND LOCAL GOVERNMENT REVENUE FROM OWN SOURCES, 1975
(Percentage Distribution)

STATE GOVERNMENT

State	General Sale and Gross Receipts	Income Taxes		License and Other	Charges and Misc.
		Individual	Corporation		
U.S.	23.9	10.4	3.7	6.3	9.2
Alabama	33.7	8.7	2.7	5.9	13.2
Arkansas	35.4	11.1	4.8	5.9	9.0
Florida	35.1	--	3.0	8.3	7.3
Georgia	28.1	10.8	3.4	2.2	7.5
Kentucky	30.9	11.0	5.2	9.8	12.0
Louisiana	23.4	3.7	2.7	22.5	13.4
Mississippi	41.1	6.5	2.4	5.7	11.2
North Carolina	28.6	16.3	4.9	6.4	10.4
South Carolina	34.2	12.0	4.7	3.4	15.7
TENNESSEE	31.1	0.7	4.9	8.2	9.0
Virginia	22.9	15.1	3.2	4.7	13.1
West Virginia	46.0	10.1	1.6	5.0	9.3
Southeastern Mean	32.5	9.6	3.6	7.3	10.9

LOCAL GOVERNMENT

State	Property Taxes	Other Taxes	Charges and Misc.	Local Government as Percent of S + L
U.S.	27.6	6.2	12.7	46.6
Alabama	7.5	10.3	17.9	35.7
Arkansas	16.5	1.5	15.8	33.8
Florida	21.7	4.3	20.3	46.3
Georgia	22.8	4.6	20.5	48.0
Kentucky	12.7	5.2	13.2	31.2
Louisiana	11.1	10.1	12.9	34.1
Mississippi	15.7	1.7	15.8	33.2
North Carolina	18.1	3.9	11.4	33.5
South Carolina	15.9	1.1	13.1	30.0
TENNESSEE	19.0	9.6	17.6	46.2
Virginia	21.1	10.2	[illegible].6	40.9
West Virginia	15.3	3.1	[illegible].7	28.1
Southeastern Mean	16.5	5.5	[illegible].8	36.8

SOURCE: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federation 1976-77, Vol. II-Revenue and Debt, Table 26, p. 41.

The Responsiveness of Tennessee's State-Local Tax System

Changes in the economic or tax base of a state will be reflected in tax collections. However, the extent that tax revenues will vary depends upon the structure of the tax system and the characteristics of the individual taxes. The responsiveness of taxes and tax systems is quantified by the elasticity increase. This measure relates the percentage change in the economic base to the percentage change in tax revenues. If the tax revenues from a single tax or tax system change (assuming no rate changes) by a greater percentage than the tax base, then the tax or tax system is considered elastic.

If the reverse is true, then the tax or system is called inelastic. When both change by the same percentage, the tax or tax system is called unitary elastic.

The responsiveness of a tax is determined by (1) the relationship between the tax base and economic growth and (2) the characteristics of the tax. Each tax has an individual elasticity measure as shown in Table 4-8, which presents the Tennessee taxes. In the same table, the ranges of elasticities of the same taxes in other states, as calculated by the Advisory Commission on Intergovernmental Relations, are presented for comparison. The taxes related to personal income, either directly or indirectly through consumption, are more elastic.

The overall elasticity of the tax system is determined by the mix of the tax structure. The more dominant the elastic taxes are in the mix, the more elastic the system. The more dominant the inelastic taxes, the more inelastic the tax system. Table 4-9 compares the system elasticities of the various states in the southeastern region. It is

TABLE 4-8

INCOME ELASTICITIES OF MAJOR STATE TAXES

Tax	ACIR	Tennessee Study
Individual Income	1.50 to 1.80	1.25
Corporation Income	1.10 to 1.30	1.11
General Sales	0.90 to 1.05	.89
Selective Sales		
Motor Fuel	0.40 to 0.60	1.57
Tobacco	0.30 to 0.40	.35
Alcoholic Beverages	0.40 to 0.60	.72*
Public Utilities	0.90 to 1.00	--
Other	0.90 to 1.10	--
Motor Vehicle Fees	--	.37
Estate	--	1.28
Total State Taxes	--	.79

*This elasticity is somewhat overestimated because of the extended areas in which liquor licenses have been granted in recent years.

SOURCE: Advisory Commission on Intergovernmental Relations, Sources of Increased State Tax Collections: Economic Growth vs. Political Choice (Washington: Government Printing Office, 1968), Table 2. Tennessee's elasticities were calculated by Tennessee Department of Revenue, Research Section, 1967.

TABLE 4-9

ELASTICITY OF STATE TAX SYSTEMS
TO PERSONAL INCOME, TENNESSEE
SELECTED STATES 1970

State	Personal Income Tax	Elasticity	State	Personal Income Tax	Elasticity
Alabama	Yes	1.02	Mississippi	Yes*	1.04
Arkansas	Yes	1.24	North Carolina	Yes	1.09
Florida	No	.87	South Carolina	Yes	1.05
Georgia	Yes	1.11	Tennessee	No	.90
Kentucky	Yes	1.12	Texas	No	.83
Louisiana	Yes*	.96	Virginia	Yes	1.22
Maryland	Yes	.89	West Virginia	Yes	.90

*However, little emphasis is placed on this tax.

SOURCE: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1976-77 Edition, Vol. 11 (Washington: Government Printing Office, 1977), Table 32.

evident that since the personal income tax is elastic, those states which utilize this tax will have a more elastic system.

The importance of elasticity, or the responsiveness of a tax system, is emphasized by examining the projected trend of taxes in Tennessee with the estimated level of expenditures. The growth in tax revenues resulting from economic growth in Tennessee is considerable, but it will be inadequate to meet projected expenditure needs. Historically the growth of governmental expenditures has been greater than that of revenues; both have grown at a faster rate than the private economy. Tax rates have been and must be periodically raised and bases broadened to provide the required funds.

Table 4-10 presents estimates of state and local general revenues and expenditures for selected years up to 1990 using the current tax structure. Between 1974 and 1990 it is estimated that the Tennessee state-local tax structure will yield $67.4 billion and estimated expenditures will be $74.3 billion. The cumulative deficit is thus estimated as $6.9 billion with a deficit of $847.5 million in the single year of 1990.

Estimated expenditure levels could be met without a deficit by gradually increasing the state-local general sales tax to between 7.0 and 8.0 percent, or by increasing general property taxes by 66.5 percent above the present level or by raising various other tax rates and broadening tax bases.

Figure 1 depicts the revenue gap at the state level that would have developed if no adjustments had been made in tax rates and bases in the period 1969-1972. Figure 2 presents the commission's projections of direct general revenues and general expenditures to 1990.

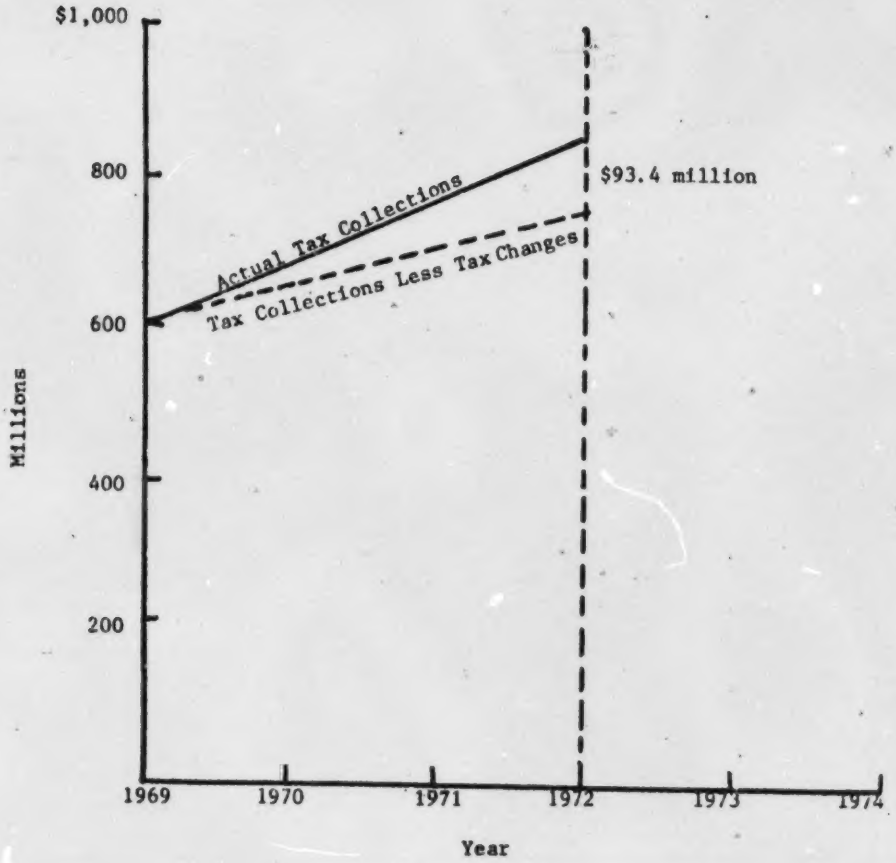
TABLE 4-10

ESTIMATES OF TENNESSEE STATE-LOCAL GENERAL REVENUE AND DIRECT GENERAL EXPENDITURES, SELECTED YEARS: 1974-1990
(In Millions)

Year	General Revenue		Direct General Expenditures		Deficit	Cumulative Deficit
	Annual	Cumulative	Annual	Cumulative		
1974	$2,457.9	$ 2,457.9	$2,457.9	$ 2,457.9	$ --	$ --
1980	3,398.2	20,056.2	3,688.7	21,271.0	290.3	1,214.8
1985	4,537.5	40,328.9	5,053.7	43,638.0	516.2	3,309.1
1990	6,076.6	67,447.3	6,924.1	74,282.9	847.5	6,835.6

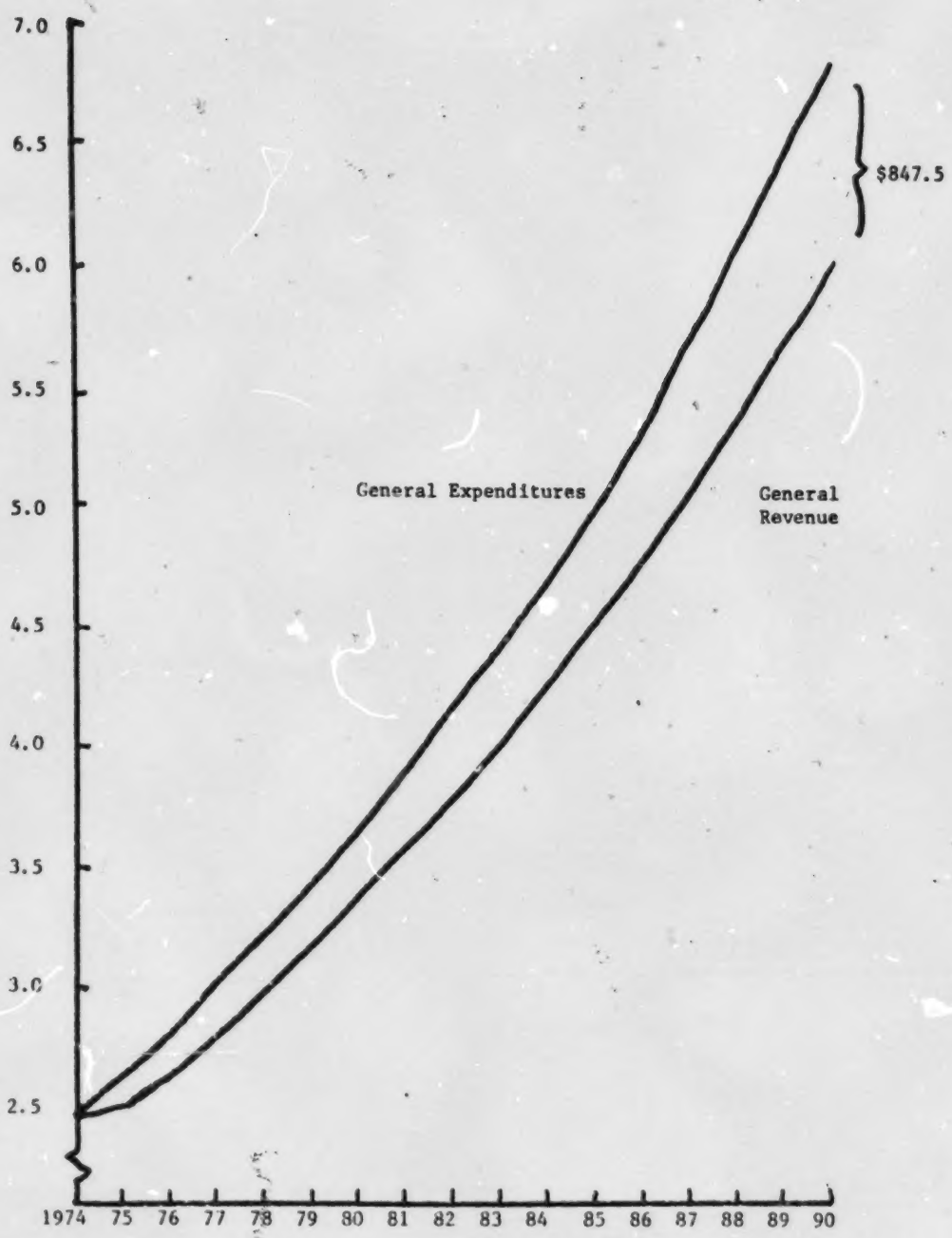
SOURCE: Data prepared by the Staff, Tennessee Tax Modernization and Reform Commission.

FIGURE 1. THE TENNESSEE REVENUE GAP, 1969-72



SOURCE: Tennessee Department of Revenue, Research Section

FIGURE 2. PROJECTIONS OF TENNESSEE STATE-LOCAL DIRECT GENERAL EXPENDITURES AND GENERAL REVENUES, 1974-1990



Tax Capacity, Effort and Burden

The tax capacity of a state is measured by the total taxable resources under its jurisdiction. To the extent that the state and local governments make use of these taxable resources, the tax effort is considered high or low. Tax burden refers to the distribution of the tax payments among families and individual taxpayers.

Tax effort is usually measured as a proportion of tax ability. This presupposes that ability can be measured. Generally this cannot be done accurately and economically, so studies of tax effort and jurisdictional comparisons commonly resort to proxies representing aggregate tax ability. A proxy measure is entirely adequate for comparative and relative measures if the proxy correlates with tax ability in the jurisdictions being compared and measured.

Tax burden studies measure the distribution of the tax effort (collections) among the family and individual taxpayers--generally among several income classes ranging from low to high income levels. This requires a distribution of the various taxable bases among the taxpayer classes; that is, the distribution of taxable expenditures, property, sales, etc., by income class. These data, too, are extremely scarce and unreliable. Burden studies also depend on proxies or partial data for distributing the tax bases among income classes.

State-Local Tax Effort in Tennessee

The most readily available proxy, and one commonly used, for tax capacity is personal income. It, however, does not measure the property and corporation business activity elements in taxable resources. For this reason, it might not effectively measure comparative tax ability

and effort among jurisdictions that differ in the relationships between personal income and property and business activity. To overcome this weakness, the Advisory Commission on Intergovernmental Relations,[3] using a "representative tax system," computed relative tax abilities for the states. Revenue potential was defined as the total amount of revenues that would result by applying the national average rate of numerous kinds of state and local revenue sources to the appropriate base in each state.

State and local taxes are presented on a per capita basis and as a percentage of personal income in Table 4-11. Only minimal differences between 1967 and 1976 are evident in the increase in effort in the fifty states, the southern states and Tennessee. In all cases per capita taxes more than doubled and the percentage of personal income represented by state and local taxes increased approximately 21 percent. In 1976 state and local taxes represented 12.0 percent of personal income in the fifty states, 10.5 percent in the southern states and 10.0 percent in Tennessee. An alternative measure of relative ability and effort was employed by Kenneth Quindry in the SREB reports from which the data in Table 4-11 were derived.[4] In the reports, tax ability for each state was assumed equal to the return from fourteen major taxes levied at average rates plus additional amounts collected from other minor tax

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3. Advisory Commission on Intergovernmental Relations, Measuring the Fiscal Capacity and Effort of State and Local Areas (Washington: U.S. Government Printing Office, 1971).

4. This procedure is similar to that employed by the ACIR. Average rates were computed for each tax, and the rate was levied against each state's tax base. While the aggregate base was broader than personal income, it did not adjust for the influences of tourism and special industries that expanded the effective tax bases of several states.

TABLE 4-11

STATE AND LOCAL TAXES PER CAPITA AND AS A PERCENTAGE OF PERSONAL INCOME
TENNESSEE, ALL STATES, U.S. REGIONS, AND SELECTED SOUTHERN STATES,
SELECTED YEARS, 1967-1976

State and Region	1967		1968		1970		1973		1976	
	Per Capita	As a Percentage of Personal Income	Per Capita	As a Percentage of Personal Income	Per Capita	As a Percentage of Personal Income	Per Capita	As a Percentage of Personal Income	Per Capita	As a Percentage of Personal Income
ll States	$310	9.9	$339	10.0	--	11.1	$586	11.6	$738	12.0
ew England States	337	9.6	363	9.6	--	11.0	669	12.8	811	12.8
iddle Atlantic States	376	10.5	410	10.6	--	11.9	743	13.4	926	13.9
orth Central States	305	9.5	331	9.4	--	10.8	566	10.6	697	11.0
ountain States	319	11.5	337	11.1	--	11.3	510	10.8	673	11.9
acific States	401	11.2	460	11.9	--	12.4	705	12.8	931	13.8
outhern States	247	9.2	264	9.0	--	10.0	451	9.9	576	10.5
labama	194	9.0	211	8.9	--	9.5	366	9.1	469	9.6
rkansas	200	9.5	205	8.8	--	9.2	349	8.7	461	9.4
lorida	277	9.7	291	9.2	--	9.9	507	10.0	578	9.9
eorgia	228	9.0	250	9.0	--	9.6	434	9.9	556	10.4
entucky	216	8.9	227	8.6	--	9.9	408	10.0	552	10.7
ouisiana	261	10.6	282	10.7	--	11.1	458	11.4	616	12.0
aryland	327	9.5	362	9.6	--	11.3	631	11.5	814	12.1
ississippi	197	10.4	204	9.8	--	11.8	391	10.7	495	11.4
orth Carolina	227	9.3	244	9.2	--	10.2	437	9.9	538	10.4
outh Carolina	201	9.1	204	8.6	--	9.6	401	10.1	500	10.3
ennessee	211	8.8	229	8.8	--	9.7	417	9.6	519	10.0
exas	229	8.3	242	8.0	--	9.4	435	9.2	595	10.1
irginia	245	8.7	273	8.9	--	9.7	494	9.8	623	10.4
est Virginia	229	9.8	254	10.4	--	10.3	426	10.5	592	11.5

OURCE: Kenneth E. Quindry, et. al., State and Local Revenue Potential (Atlanta: Southern Regional Education Board); population for 1967, U.S. Bureau of the Census, Governmental Finances in 1967-68, Series GF68, No. 5, Table 26.

sources. Tax effort was represented as the degree of utilization of tax ability.

The data in Table 4-12 indicate that the southern region makes less use of its taxing ability than do other regions. Tennessee state and local government effort is a little below the average for southern states but 15 percent below the national average. In fact, Tennessee state and local governments would have collected $610 million in additional taxes had average rates been applied in every one of the fourteen major taxes.

In Tennessee, as in other states, some taxes were overutilized, others underutilized. In general, southern states overutilize consumption taxes and underutilize property and income taxes. Tennessee is no different from the typical southern state. Table 4-13 lists the fourteen major taxes and the amount of over-or underutilization for each tax.

This report does not intend to imply that all states should levy uniform and average rates for every major tax; it merely indicates relative effort. States may prefer, for economic, political or social reasons, to concentrate their efforts in some taxes while minimizing other taxes. Aggregate underutilization can be justified on the basis of below-average expenditure needs in relation to ability. Other justifications are low personal income, relatively large numbers of the taxpayers in low income classes and a highly regressive tax system. These last justifications increase the effective tax burdens immediately on the low income taxpayers at every level of effort even if basic expenditure needs are not being met.

TABLE 4-12

PERCENTAGE OF TAXABLE CAPACITY UTILIZED
TENNESSEE, ALL STATES, U.S. REGIONS
AND SELECTED SOUTHERN STATES, 1976

State and Region	Percentage	State and Region	Percentage
All States	95.4	Kentucky	81.9
New England	105.3	Louisiana	82.7
Middle Atlantic States	111.9	Maryland	98.7
North Central States	89.3	Mississippi	88.4
Mountain States	90.2	North Carolina	82.3
Pacific States	111.2	South Carolina	81.9
Southern States	80.9	Tennessee	78.2
Alabama	73.7	Texas	75.9
Arkansas	73.5	Virginia	82.0
Florida	78.1	West Virginia	83.9
Georgia	83.3		

SOURCE: Kenneth E. Quindry, State and Local Revenue Potential 1976 (Atlanta: Southern Regional Education Board, 1977), Table 21.

TABLE 4-13

UTILIZATION OF STATE AND LOCAL TAX CAPACITY, TENNESSEE

Tax	1976 (In Thousands) Overutilization	Underutilization
General Sales Taxes	$188,907	$ --
Elective Sales Taxes		
Alcoholic Beverages	29,892	--
Tobacco Products	7,759	--
Insurance	6,095	--
Public Utilities	42,595	--
Other	--	21,419
State Death and Gift Tax	5,736	--
Property	--	394,082
Individual Income	--	475,812
Corporation Income	--	2,500
State Alcoholic Beverage Licenses	--	1,714
Motor Vehicle Licenses	9,493	--
Motor Fuels	9,839	--
Severance	--	15,829
Transfer	2,450	--
Totals	302,765	911,356
Net Underutilization		608,592

SOURCE: Kenneth E. Quindry, State and Local Revenue Potential, 1976 (Southern Regional Education Board, 1977), Table 34.

State-Local Tax Burdens in Tennessee

The burden of taxation is related to the level of taxation and to the distribution of the tax effort. A well-designed state-local tax system is one that is basically neutral as to the redistribution of income and economic activity among taxpayers.

Most students of state-local public finance now favor a tax system that is reasonably close to proportional in regard to the income of family and individual taxpayers. They argue that much of the income of high-income individuals is spent less on necessities and more on luxuries. Consequently large tax burdens on the wealthy merely reduce unncessary expenditures, whereas large tax burdens on the low-income individuals reduce their consumption of basic necessities. Low-income individuals can ill afford socially necessary items such as food and shelter after paying a high rate of taxation.

Because each tax used by state and local governments results in a unique distribution of tax burden, the mix of taxes within the structure will determine the distribution of tax burden on families in any particular state. The percentages presented in Table 4-14 illustrate the effect of utilizing certain taxes on the distribution of tax burden.

Although all states in the SE region have regressive state-local tax structures, Florida is the only state where the tax burden from total state-local taxes is distributed more regressively than Tennessee. When the information in Table 4-14 is related to that in Table 4-7, the influence of certain taxes on the equity of a tax structure becomes evident. First, Florida has no personal income tax and relies heavily on the general sales tax. The local governments in Florida utilize

TABLE 4-14

DISTRIBUTION OF MAJOR STATE-LOCAL TAX BURDENS
RELATIVE TO FAMILY INCOME SIZE, BY STATE, 1974
(Tax Burdens Percentages of Income)

State	Adjusted Gross Income, Family of Four, 1974					
	$5,000	$7,500	$10,000	$17,500	$24,000	$50,000
U.S.	11.3	10.0	8.9	8.5	8.1	7.8
Alabama	9.8	8.7	8.2	7.6	7.2	6.4
Arkansas	8.5	7.8	7.0	6.8	6.8	7.4
Florida	7.5	6.0	4.9	4.2	3.5	2.6
Georgia	10.6	8.9	7.8	8.1	8.1	8.0
Kentucky	9.5	9.6	9.0	8.6	8.4	7.7
Louisiana	6.1	5.0	4.6	4.1	3.7	3.6
Mississippi	6.8	5.2	6.6	4.9	4.7	4.5
North Carolina	10.3	9.6	9.0	8.9	8.8	8.8
South Carolina	9.1	7.9	7.3	7.6	7.7	8.0
TENNESSEE	10.5	8.7	7.2	6.2	5.2	4.0
Virginia	10.0	8.6	7.9	8.2	7.8	7.5
West Virginia	7.7	6.4	5.6	5.2	4.9	5.1
SE Region Avg.	8.8	7.7	7.1	6.7	6.4	6.1

SOURCE: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism 1976-77, Vol. II, Revenue and Debt, Table 28, p. 45.

charges and miscellaneous sources of revenue to a greater extent than the national average and the average of other states in the SE region. All these taxes are regressive; thus, the total tax structure of state and local governments reflects this inequity. Second, Tennessee raises a very small percentage of total revenue from personal income tax. Because the base is limited to interest and dividends, the revenues account for a small proportion of the total. Tennessee, like Florida, relies more on charges and other taxes than other states. The data from Florida and Tennessee support the contention that the mix of taxes has a great influence on the distribution of burden and whether a tax structure is equitable relative to those in other states.

In a study by Kenneth E. Quindry and Mary Currence[5], the effect of tax mix on the equity of a tax structure was clearly reflected in the regressivity indexes which were calculated for selected southern cities. The index was developed by dividing the percentage of income paid in taxes at the lowest income level ($5,000) by that at the highest income level ($35,000). The resultant figure indicates the degree of regressivity (or progressivity) of the tax structure. An index of 1.00 indicates proportionality. An index rating of 3.00 or more shows extreme regressivity. The reported measures show the regressive nature of the tax burden placed on residents in Tennessee cities. Of the seven southern cities with a population above 500,000, Memphis is the most regressive with an index of 3.16. Among the nine cities with populations between

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5. Kenneth E. Quindry and Mary Currence, Relative Family Tax Burdens in Southern Cities, Center for Business and Economic Research, The University of Tennesee, Knoxville, December 1976.

250,000 and 499,999, Nashville is the most regressive with an index of 3.15. Of the twenty-seven cities with a population between 100,000 and 249,999, Chattanooga and Knoxville are the most regressive with indexes of 3.18 and 3.21 respectively.

State and Local Expenditures

Because the above comparisons of the tax burden are very simplistic and hide more than they reveal, it is worthwhile to examine the manner in which tax revenues were spent in order to ascertain the changing role of the public sector in the various southeastern states. One measure of the relative participation of the public sector in the overall economy is the amount spent on general direct expenditures like education, highways, health, public welfare and others. The gross amounts are not as meaningful as the per capita amounts and amounts per $1,000 of personal income. Table 4-15 presents the annual rates of change between 1963 and 1976 of both local and state governments in the 14 southeastern states. These rates were calculated in current dollars and in 1958 dollars. The expenditures were deflated by the State and Local Government Expenditure Deflator, and the income totals were deflated by the Consumer Price Index.

The comparison of the local government expenditure in Tennessee on a per capita basis and per $1,000 of personal income shows that, although there were annual increases of 9 and 1 percent in current dollars respectively, in real terms the local governments spent 3 percent more each year per capita and kept the dollars spent per $1,000 of personal income constant. This growth rate was slower than that of local governments in several other states in the southern region.

Chapter V

AN ANALYSIS AND EVALUATION OF TENNESSEE'S STATE AND LOCAL TAXES

Introduction

In the previous chapter, the characteristics of the state-local tax system were discussed. Although some mention was made of the importance of the tax mix of a system, most of the attention was devoted to the analysis and comparison with other states. In this chapter attention will be devoted to the examination of the various taxes which make up the Tennessee state-local tax system. However, it should be kept in mind that the strength of any fiscal system is dependent on the structure of each tax and the relative importance of each tax in the system.

Tax systems are initially designed to raise revenues. Each system attempts to make maximum use of the available resources. As revenue requirements grow, as economic conditions change and as social and economic goals take precedence, taxes are changed and new ones are added. Consequently, the effects of the total tax structure are altered. It becomes imperative that we are aware of the particulars of each tax.

There is more to discussing the characteristics of a tax than the specification of its rate and tax base. Equally as important are several objective standards which are used to measure the effects of a tax on individuals, businesses and economic activity. The four standards which can be used as criteria for evaluation are (1) equity, (2) efficiency, (3) adequacy and (4) economic effect. These are all relative measures, and the determination of whether a tax is "good" or "bad" does not depend on the tax meeting certain minimum levels of the four standards. Rather the standards are important elements to be considered when judging the merits of a tax.

For a tax to be equitable, it must be fair. It is apparent from this definition that, to a large extent, equity is a subjective assessment based on personal values. In order to present value judgments in a meaningful manner, tax students, legislators, etc., have devised quantifiable measures. These measures, such as tax paid per capita, tax paid per $1,000 of income and amount of tax paid as a percent of income, are used to judge the relative equity of a tax.

Efficiency has traditionally meant the taxpayer should know how much he is paying in taxes and on what he is paying. The time and manner of payment should be as desirable as possible and the compliance and collection costs should be low. Thus, efficiency means a tax should have certainty of collection, be convenient and be economical.

The adequacy of a tax is important when the revenues are necessary to support a particular state or local activity. Also, the revenues from any single tax must be enough to warrant the expense of collection. However, one must not use only the conditions of adequacy to judge a good tax.

Careful consideration of the economic effects of a tax is important in any tax policy. Whether the tax directly affects the decisions of individuals and businesses or indirectly affects choice through the price mechanisms, the total effect is relevant. It is not so much who pays the tax bill to the taxing jurisdiction as it is who actually experiences the decrease in income or wealth when the tax is levied. Frequently the taxpayer is able to shift the tax either onto a buyer of the service or product in the form of higher prices or backward onto owners of resources in the form of lower wages or payments. The final impact may differ when consideration is given to the passage of time.

As time elapses the tax effects are more generally dispersed throughout the economy.

All these changes: prices, wages, costs, profits, etc., combine to affect economic activity in some manner. It is not always possible to ascertain, with any degree of precision, the result, but awareness of the direction of change is sometimes very valuable.

TABLE 5-1

THE PROBABLE INCIDENCE OF TAXES

Type of Tax	Probable Incidence
Personal Income Tax	The household or individual upon which it is levied.
Corporation Income Tax	Disagreement. Some economists feel the firm on which it is levied bears the incidence; others conclude the tax is shifted in whole or in part to consumers.
Sales and Excise Taxes	With exceptions, consumers who buy the taxed products. Tax may be shifted by businesses which are consumers of taxed products.
Property Taxes	Owners in the case of land and owner-occupied residences, tenants in the case of rented property, consumers in the case of business property.

In the following sections of this chapter property taxes, income taxes, general sales and use taxes, selective sales taxes and other taxes, licenses and fees will be discussed with emphasis placed on the equity, efficiency, adequacy and economic effect of each tax. In addition, appropriate comparisons with other states will be included.

Property Taxes

The property tax is a locally administered, flat proportional rate tax based upon the assessed value of property. Locally assessed real estate makes up a predominant part of total taxable assessed valuation. In 1971 it contributed 81 percent of the tax base in Tennessee, with state assessed utility property accounting for 9.5 percent and locally assessed personal property for the other 9.5 percent.

In 1967 the legislature set requirements for assessment levels in the form of minimum fractions as follows: 15 percent for 1968; 25 percent for 1969; 30 percent for 1970; 35 percent for 1971; 40 percent for 1972; and 50 percent for 1973 and thereafter. However, by constitutional amendment in 1972, a classification system was adopted by which different levels of assessment relative to actual market value were specified as follows:

1)	state assessed public utilities	55 percent
2)	commercial and industrial real estate	40 percent
3)	commercial and industrial personal property	30 percent
4)	residential and farm properties	25 percent
5)	non-business tangible personal property in excess of $7,500 per owner	5 percent

In the same amendment property tax relief was given to limited-income, elderly homeowners (65 and over) and the totally disabled. A qualified individual with income less than $4,800 is entitled to claim a reimbursement from the state on the first $1,250 of assessed value of his owner-occupied residence. This tax-relief program enabled Tennessee to be included among the 50 states which offer some form of property tax relief. As of 1976, 25 states (Tennessee not included) had enacted some form of a circuit-breaker, property-tax relief program. Only three of the southern states, Arkansas, Maryland and West Virginia, were among the 25 states.

In 1976 Tennessee raised $545.7 million from the property tax. As presented in Table 5-2, this was 26.3 percent of total state and local tax revenues. When compared to other states, this percentage was about average for the southeastern states but below the national average. Only Texas, of all the southeastern states, was equal to or above the average for all states. All other southeastern states raised a smaller percentage of tax revenues with the property tax than the average of 36.4 percent.

Adequacy

The concept of adequacy is difficult to judge. However, when the effective rate (Table 5-2) in Tennessee plus the low percentage utilization of the property tax (Table 5-3) are considered, the conclusion is that the state is not raising adequate revenues with this taxing instrument. By increasing the local rates, more revenue could be raised and used to affect the heavy reliance upon the general sales tax.

Equity

The burden of the property tax on the various income levels of taxpayers in Tennessee is not readily available. A study by Kenneth Quindry and Mary Currence in 1973 showed some detail about the distribution of property tax. As reflected in Table 5-4, the property tax is regressive; the percentage of income paid in property tax going from 4.76 percent to .98 percent as income increased.

Another interesting fact about the property tax is that low income homeowners pay, in total, a considerably larger percentage of the property tax.

TABLE 5-2

AVERAGE EFFECTIVE PROPERTY TAX RATES*
BY STATE, SELECTED YEARS 1958-1975

State	1975	1971	1966	1962	1958
Alabama	.75	.85	.66	.52	.56
Arkansas	1.41	1.14	1.09	1.09	.84
Florida	1.18	1.41	1.09	.66	.76
Georgia	1.33	1.44	1.30	.94	.84
Kentucky	1.23	1.27	1.03	.94	.93
Louisiana	.64	.56	.43	.49	.52
Maryland	2.01	2.24	2.05	1.74	1.47
Mississippi	1.12	.96	.93	.76	.66
North Carolina	1.51	1.58	1.31	1.17	.90
South Carolina	1.07	.94	.60	.53	.48
Tennessee	1.31	1.53	1.37	1.18	.97
Texas	2.06	1.91	1.52	1.44	1.36
Virginia	1.32	1.32	1.13	1.03	.90
West Virginia	.78	.69	.71	.79	.56
U.S.	1.89	1.98	1.70	1.53	1.34

* Existing single-family homes with FHA insured mortgages.

SOURCE: ACIR, Significant Features of Fiscal Federalism, 1976-77, Vol. II, Revenue and Debt, Table 71, March 1977.

TABLE 5-3

STATE AND LOCAL PROPERTY TAX AS PERCENT
OF TOTAL TAX REVENUE SOUTHERN STATES

State	1971	1973	1976
All States	39.9	37.3	36.4
Alabama	14.8	13.2	12.6
Arkansas	25.6	23.0	22.2
Florida	33.9	29.2	33.8
Georgia	32.2	29.1	32.4
Kentucky	22.2	19.3	19.1
Louisiana	19.0	17.6	14.8
Maryland	32.8	31.2	29.4
Mississippi	24.3	22.2	22.5
North Carolina	25.2	23.6	24.7
South Carolina	22.2	21.4	23.7
Tennessee	28.2	26.3	26.3
Texas	40.0	38.4	36.7
Virginia	29.4	27.1	28.3
West Virginia	22.2	20.0	18.1

SOURCE: Department of Commerce, Bureau of the Census, selected years.

TABLE 5-4

PROPERTY TAX BURDENS BY HOUSEHOLD INCOME CLASS
TENNESSEE 1970

Household Income Class	Percent of Total Taxes Paid	Average Tax Paid	Percent of Income Paid in Taxes
Less than $3,000	10.60	$ 95	4.76
$3,000 - $4,999	7.55	105	2.61
$5,000 - $6,999	9.49	115	1.92
$7,000 - $9,999	18.40	137	1.61
$10,000 - $14,999	27.45	178	1.42
$15,000 - $24,999	18.45	243	1.21
$25,000 or more	7.78	341	0.98
Total	100.00	153	1.56

SOURCE: Kenneth E. Quindry and Mary G. Currence, Tennessee Homeowner Property Tax Burdens, Table VI, p. 12.

The calculations of the distributions of the property tax in Table 5-4 do not include taxes which are paid on non-residential property. If the assumption is made that these taxes are shifted forward in the form of higher prices, then the consumer is bearing the burden in proportion to expenditures on goods and services. If this is the correct assumption, then the burden of this portion of the property tax is also regressive and adds to the overall regressivity of the tax.

Economic Effects and Comparison With Other States

The primary economic effect of property tax rates and administration is the influence they have on business location and activity. The impact on business is through the cost of production. Higher taxes which are not payments for improved or increased services necessitate higher prices, and Tennessee firms could become non-competitive with firms operating in other states.

Table 5-3 shows the effective rates of southeastern states. Tennessee is not too far out of line with other states in the region. The objective should be to keep taxes in line with the surrounding area, while at the same time not subsidizing businesses with tax concessions. The goal should be to provide adequate services at reasonable tax rates and not to ask business to subsidize other sectors of the economy.

The Income Tax-Personal Income Tax

The Tennessee income tax, first enacted in 1929 and based on income from stocks and bonds, is an example of the type of income tax authorized by the Tennessee constitution. Amendments in 1937 increased the tax rate from 5 percent to 6 percent and taxed (at the rate of 4 percent) income from stock in corporations, 75 percent of whose property was subject to Tennessee ad valorem taxes. These rates are still in effect today but subsequent amendments have narrowed the base.

Of the 44 states in 1976 which had some form of income tax, only New Hampshire and Connecticut have a limited income tax similar to that of Tennessee. In 1976 Tennessee generated approximately $22 million from the personal income tax. This amounted to 1.7 percent of total state tax revenues (Table 5-5). The percentage of state tax revenue attributed to the personal income tax is far below both the national average of 27.2 percent and the averages of other states in the southeastern region.

Because Tennessee's personal income tax is applied to interest and dividends only, it is difficult to calculate comparative effective rates with other states. The only substantive conclusion is that since the rate is applied to a relatively small specialized tax base, the burden

TABLE 5-5

PERCENT OF STATE TAX REVENUE FROM INDIVIDUAL INCOME, AND CORPORATION INCOME TAXES, BY STATE

State	Individual Income Tax		Corporation Income Tax	
	1975	1967	1975	1969
Alabama	19.5	13.0	4.8	5.0
Arkansas	20.4	11.9	7.8	7.0
Florida	--	--	6.2	--
Georgia	24.6	16.8	7.9	8.8
Kentucky	27.6	16.4	9.6	6.0
Louisiana	7.1	5.7	5.3	4.5
Maryland	58.1	36.3	5.6	6.3
Mississippi	11.9	5.1	4.6	8.3
North Carolina	29.4	23.7	7.6	11.1
South Carolina	23.5	18.1	7.6	8.7
Tennessee	1.7	1.8	10.1	9.5
Texas	--	--	--	--
Virginia	33.2	29.6	7.0	7.3
West Virginia	16.6	8.9	2.4	1.2
U.S. Average	27.2	18.0	8.1	7.6

SOURCE: ACIR, Significant Features of Fiscal Federalism, 1967-77, Vol.II, Revenues and Debt, Table 10, 1977. Kenneth E. Quindry and Niles Schoening, State and Local Revenue Potential, 1976, Southern Regional Education Board, 1977. Tables 5 and 4.

distribution will be either proportional or slightly progressive above the lower income levels.

The Tennessee tax is simple to administer. However, because it is levied on such a small base, it is very underutilized. According to the calculations made by Quindry and Schoening in the State and Local Revenue Potential, 1976, Tennessee's personal income tax was underutilized to the amount of $475.8 million. The measure of underutilization is calculated by applying a national average rate structure to the tax base in Tennessee to get the potential amount. The actual collections are subtracted from this potential to arrive at the underutilized amount.

The Income Taxes: The Corporation Income Tax

In Tennessee the corporation income tax goes by the name of excise tax. This tax was first enacted in 1923 and has continued to be a productive source of revenue for the state. The excise tax is legally a privilege tax imposed equally on domestic and foreign corporations for the privilege of doing business in Tennessee for a profit. The determination of the portion of net earnings attributed to business done in Tennessee is computed by taking the average of the following three ratios:

(1) $\frac{\text{Value of real and tangible personal property owned and rented and used in the business in Tennessee}}{\text{Value of real and tangible personal property owned and rented and used in the business owned everywhere}}$

(2) $\frac{\text{Total payroll in Tennessee}}{\text{Total payroll everywhere}}$

(3) $\frac{\text{Total sales in Tennessee}}{\text{Total sales everywhere}}$

Separate accounting and variations from the formula are permitted if the above ratios do not fairly represent the extent of the taxpayer's business

in Tennessee. Common carriers and utilities also have alternative formulas in some cases.

In 1976 approximately $129 million, or 10.1 percent of all state tax revenues, came from the 6 percent corporation income tax (excise tax). The proportion of total state tax revenues accounted for by this tax in Tennessee exceeds any percentage in the southeastern region and the national average. When compared to the personal income tax, it is apparent that Tennessee relies more heavily on the business tax and less on the personal income tax than other states in the region.

It is difficult to assess the burden and economic effects of the corporation income tax in Tennessee. To the extent that it is shifted forward onto the consumer in the form of higher prices, it will be regressive. To the extent it is absorbed by the owners of capital in the form of lower net profits, it could be detrimental to economic growth and development in the state.

General Sales and Use Taxes

The retail sales and use tax, imposed in 1947, collected $556.7 million for the state and $171.5 million for local governments in 1976. The major purpose in enacting the state tax was to provide funds for state and county education programs and the bulk of revenues collected has been devoted to this purpose. At present 86.23 percent of the revenues from the state tax is earmarked for education; 8.26 percent is apportioned to incorporated municipalities on a population basis. The remainder is earmarked for the General Fund, the Sinking Fund and the Human Services Department.

The tax is a tax on the retailer, which by law is shifted to the consumer. It is applied to the sale, use, consumption, distribution,

base or rental of tangible personal property and a few selected services. Amendments since 1947 have altered the tax by extending it to include services and utilities.

The present state rate is 4.5 percent. Tennessee permits its counties and municipalities to levy rates equal to one-half (½) of the state rate, or in this case 2¼ percent.

In 1971, the sales and use tax raised $262 million, or 32.1 percent of all state tax revenue. In 1976, the tax raised $556.7 million, or 43.7 percent of total state tax revenues. In Table 5-6, it is shown that Tennessee relies on the sales and use tax for a substantial proportion of its revenues. When compared to other states both on a per capita and income basis, Tennessee is high. The $153.27 per capita and $33.20 per $1,000 personal income in 19 are high relative to all other states. In the southeastern region these measures are exceeded only by Louisiana, Mississippi and West Virginia.

The equity of the sales and use tax can be described as regressive. The only difference among the 46 states (Alaska has only a local tax) is the degree of regressivity which is determined by the various types of exemptions and credits. Tennessee is not among the 22 states which exempt food from the tax. This has been used successfully as a way of reducing the regressivity of the tax. Another way to reduce the burden on the lower income taxpayers is to allow a credit against the state income tax. Six states follow this procedure; since Tennessee does not have the personal income tax on all earned income, the credit cannot be used. This information is presented in Table 5-8.

Major advantages of the general sales taxes are their relative revenue stability (especially if a broad base is maintained); their minimal influences on economic development and location (only if certain

TABLE 5-6

STATISTICS OF STATE-LOCAL GENERAL SALES TAX COLLECTIONS
TENNESSEE, ALL STATES, U.S. REGIONS AND
SELECTED OTHER SOUTHERN STATES
SELECTED YEARS
(Indexes of Growth, 1961=100)

State and Region	Per Capita Collections		Collections Per $1,000 of Personal Income	
	1970	1975	1970	1975
All States	$ 79.87	$136.55	$ 20.12	$ 24.33
New England States	51.62	77.57	11.93	13.19
Middle Atlantic States	81.12	145.76	18.00	23.61
North Central States	73.01	124.92	19.44	21.64
Mountain States	78.25	147.89	22.00	29.21
Pacific States	110.92	190.10	25.21	30.79
Southern States	72.73	126.77	21.56	25.76
Alabama	77.20	128.43	27.01	29.66
Arkansas	56.83	100.08	20.22	23.93
Florida	99.11	143.60	26.39	26.64
Georgia	93.79	124.82	21.88	25.88
Kentucky	83.71	109.49	27.04	24.17
Louisiana	80.14	162.19	26.06	35.39
Maryland	61.23	96.63	14.11	15.61
Mississippi	103.91	165.15	40.43	42.45
North Carolina	53.38	99.10	16.44	21.39
South Carolina	74.92	119.84	25.28	27.53
Tennessee	78.97	153.27	25.37	33.20
Texas	55.39	122.63	15.42	23.91
Virginia	62.51	97.63	17.14	17.91
West Virginia	104.07	200.09	34.55	43.83

SOURCE: Indexes, The University of Tennessee, Center for Business and Economic Research, unpublished data; and Kenneth E. Quindry, State and Local Revenue Potential 1970 (Atlanta: Southern Regional Education Board, 1971), Table 13, and 1975, Table 13.

TABLE 5-7

STATE SALES TAXES: TYPES AND RATES, JULY 1, 1976
RATES ON SELECTED SERVICES SUBJECT TO TAX

State	Type of Tax	Rate on Tangible Personal Property at Retail	Admissions	Restaurant Meals	Transient Lodging	Telephone and Telegraph	Gas and Electricity	Water	Transportation
Alabama	Retail Sales	4	4	4	4	--	--	--	--
Arkansas	"	3	3	3	3	3	3	3	--
Florida	"	4	4	4	4	4	4	--	--
Georgia	"	3	3	3	3	3	3	--	3
Kentucky	"	5	5	5	5	5	5	5	--
Louisiana	"	3	3	3	3	--	--	--	--
Maryland	"	4	--	4	4	--	4	--	--
Mississippi	Multiple Stage Sales	5	--	5	5	5	5	5	--
North Carolina	Retail Sales	3	--	3	3	--	--	--	--
South Carolina	"	4	--	4	4	4	4	--	--
Tennessee	"	4½	--	4½	4½	4½	4½	4½	--
Texas	"	4	--	4	--	--	4	--	--
Virginia	"	3	--	3	3	--	--	--	--
West Virginia	"	3	3	3	3	--	--	--	--

SOURCE: ACIR, Significant Features of Fiscal Federalism, 1976-77, Vol. II, Revenue and Debt, Table 99, March 1977.

TABLE 5-8

STATE AND LOCAL SALES TAXES, JULY 1, 1978 - SUMMARY TABLE
(Percentage Rate)

State	State Rate	Local Rate (Max.)	Food Exempt	Income Tax Eredit	State	State Rate	Local Rate (Max.)	Food Exempt	Income Tax Credit
Alabama	4	3[a]	--	--	Nebraska	2½	1	--	X
Alaska	--	5[bc]	--	--	Nevada	2	1½*[f]	--	--
Arizona	4	2[c]	--	--	New Jersey	5	--	X	--
Arkansas	3	1	--	--	New Mexico	4	½*	--	--
California	4-3/4	1½*[d]	X	--	New York	4	3*	X	--
Colorado	3	3[d]	--	X	North Carolina	3	1*	--	--
Connecticut	7	--	X	--	North Dakota	4	--	X	--
Florida	4	--	X	--	Ohio	4	0.5	X	--
Georgia	3	1	--	--	Oklahoma	2	2*	--	--
Hawaii	4	--	--	X	Oregon	--	--	e	--
Idaho	3	--	--	X	Pennsylvania	6	--	X	--
Illinois	4	1	--	--	Rhode Island	6	--	X	--
Indiana	4	--	X	--	South Carolina	4	--	--	--
Iowa	3	--	X	--	South Dakota	4	2*	--	--
Kansas	3	½	--	--	Tennessee	4.5	1.75*	--	--
Kentucky	5	--	X	--	Texas	4	1*	X	--
Louisiana	3	3[c]	X	--	Utah	4	0.5*	--	--
Maine	5	--	X	--	Vermont	3	--	X	X
Maryland	4	--	X	--	Virginia	3	1*	--	--
Massachusetts	5	--	X	X	Washington	4.6	0.5*	--	--
Michigan	4	--	X	--	West Virginia	3	--	--	--
Minnesota	4	1	X	--	Wisconsin	4	0.5[e]	X	--
Mississippi	5	--	--	--	Wyoming	3	1[e]	--	--
Missouri	3	1*	--	--	District of Columbia	5	--	X	--

* Uniform State-collection of local sales taxes.

a. Locally-collected in some jurisdictions, State-collected in others.

b. The combined city-borough rate.

c. All local taxes self-administered.

d. A 1¼ percent sales tax is levied by all counties in the state.

e. Local tax authorized, but none presently imposed.

f. A one percent county tax is mandatory.

SOURCE: ACIR, Significant Features of Fiscal Federalism, 1976-77, Vol. II, Revenues and Debt, Table 96, March 1977.

changes were made to ease the burden on business purchases); their responsiveness to economic growth (elasticity coefficient is computed to be .89 in Tennessee), which is almost proportional; and the economy and efficiency of administration and compliance.

Local general sales taxes suffer from the same weaknesses as other local nonproperty taxes. The tax base is mobile if interjurisdictional rates differ. While the base can be identical to the state base and the state can collect the tax, this does not remove the effects of the interjurisdictional base disparities. The base is perhaps just as capricious in regard to expenditure needs as either the local property or income taxes.

Selective Sales Taxes

Selective sales taxes on gasoline, tobacco and alcoholic beverages are used by all states in varying degrees. The taxes are usually based on the physical sales (volume) and the burden is passed directly onto the consumer. Although the taxes on alcoholic beverages and tobacco products were initially intended to reduce the consumption of both, these taxes have turned into rather lucrative sources of state revenue.

In 1976 Tennessee collected $73 million in taxes on alcoholic beverages, $67 million from taxes on tobacco products, and $188 million from motor fuel taxes. These revenues accounted for 3.3 percent, 3.1 percent and 8.4 percent of total tax revenues respectively (Table 5-9).

The burden of these three taxes on the taxpayer is presented in Table 5-10. All three are clearly regressive over the range of personal incomes. When combined with the regressivity of the general sales tax in Table 5-10, the taxpayers of Tennessee are subjected to regressive

TABLE 5-9

STATE TAX REVENUE, BY SOURCE BY STATE, 1976
(Percentage Distribution)

State	Motor Fuels	Alcoholic Beverages	Tobacco Products	Total
Alabama	10.4	4.8	3.3	18.5
Arkansas	11.7	1.8	4.6	18.1
Florida	7.6	3.7	3.7	15.0
Georgia	8.5	4.4	2.7	15.6
Kentucky	9.3	.8	1.2	11.3
Louisiana	7.0	2.0	2.4	11.4
Maryland	5.4	.8	1.6	7.8
Mississippi	11.4	3.2	2.6	17.2
North Carolina	9.5	2.9	.7	13.1
South Carolina	9.4	4.9	1.6	15.9
Tennessee	8.4	3.3	3.1	14.8
Texas	5.7	1.8	3.8	11.3
Virginia	8.1	2.7	1.0	11.8
West Virginia	7.6	3.4	2.5	13.5
U.S.	5.5	1.6	2.3	9.4

SOURCE: Calculated from data in Kenneth E. Quindry and Niles Schoening, State and Local Revenue Potential, 1976, Tables 2, 8, 21, Southern Regional Education Board.

TABLE 5-10

EFFECTIVE TAX RATES OF SALES AND USE TAX
TOBACCO, ALCOHOLIC BEVERAGES, AND GASOLINE
TENNESSEE, 1976

Income	Sales and Use Tax	Tobacco	Alcoholic Beverages	Gasoline	Total
Under $3,000*	6.90	.79	.080	1.20	8.90
$ 3,000 - $ 3,999	6.10	.60	.080	1.22	8.02
$ 4,000 - $ 4,999	5.18	.55	.070	1.13	6.94
$ 5,000 - $ 5,999	4.81	.48	.065	1.14	6.50
$ 6,000 - $ 6,999	4.36	.46	.058	1.09	5.97
$ 7,000 - $ 7,999	4.23	.44	.061	1.11	5.84
$ 8,000 - $ 9,999	3.74	.42	.061	1.05	5.26
$10,000 - $11,999	3.52	.36	.055	.99	4.93
$12,000 - $14,999	3.33	.32	.043	.94	4.64
$15,000 - $19,999	2.95	.27	.044	.82	4.11
$20,000 - $24,999*	2.71	.27	.038	.74	3.70
$25,000 and over	2.20	.12	.040	.05	2.88

* Income used for calculations were $2,500 and $35,000 respectively.

SOURCE: Expenditure data by income bracket from Center for Business and Economic Research, The University of Tennessee, Knoxville.

taxes (sales, alcoholic beverages, tobacco and motor fuels), which account for 58.5 percent of all state and local tax revenues. When the property tax, which raises 26.3 percent of state and local tax revenues, is combined with the sales taxes (58.5 percent), 84.8 percent of the total revenues raised by taxes by state and local governments are from regressive taxes.

Other Taxes, Licenses and Fees

Although not a major source of revenue, 10.8 percent of Tennessee state and local tax revenues were derived from such sources as death and gift taxes, severance taxes, transfer taxes, alcoholic beverage licenses, motor vehicle licenses and other license taxes in 1976 (Table 5-11). In total dollars these special taxes and fees contribute a relatively stable amount to the total revenues ($143 million in 1976). The income elasticity of each source is relatively low. Therefore the revenues do not fluctuate very much in response to increases or decreases in total state income.

The details of each type of levy, either tax or license fee, differ among the 50 states and among the 14 states in the southeastern region. The main differences are the rates and treatments of tax bases. The three states, which raise high proportions of total state tax revenues from these sources, Louisiana, Mississippi and Texas, rely heavily on severance taxes because of their natural resources. With the exception of these states, Tennessee is high relative to the other southeastern states and the national average of 7.2 percent.

TABLE 5-11

PERCENTAGE OF STATE TAX REVENUE BY SOURCES, 1976

State	Death and Gift	Alcoholic Beverage License	Motor Vehicle License	Severance Taxes	Transfer Taxes	Parimutual Taxes	Other License Taxes	Total
Alabama	.29	.17	2.5	.67	.27	--	3.2	7.1
Arkansas	.22	.08	4.1	.91	.02	1.2	2.1	8.6
Florida	.78	.24	3.9	.97	2.1	1.6	1.7	11.3
Georgia	.21	.02	1.5	--	.14	--	1.0	2.9
Kentucky	.87	.06	2.5	4.8	.11	.57	1.5	10.4
Louisiana	.57	.05	1.5	23.6	--	.44	3.3	29.5
Maryland	.46	.01	2.2	--	.51	.61	.66	4.5
Mississippi	.39	.15	1.8	20.0	--	--	3.3	25.6
North Carolina	1.02	.02	3.2	--	--	--	2.8	7.0
South Carolina	.59	.15	1.8	--	.41	--	1.5	4.5
Tennessee	1.41	.04	4.4	.08	.59	--	4.3	10.8
Texas	.79	.01	3.6	10.8	--	--	3.6	18.8
Virginia	.60	.05	3.7	.02	.61	--	1.3	6.3
West Virginia	.73	.11	3.4	--	.18	1.2	1.1	6.7
U.S.	.96	.10	2.8	1.3	.35	.01	1.7	7.2

SOURCE: Calculated from data in Kenneth E. Quindry and Niles Schoening, State and Local Revenue Potential, 1976, Southern Education Board, Tables 3, 6, 7, 9, 10 and 11.

CHAPTER VI

SOME PROPOSALS FOR TAX REFORM IN TENNESSEE

Introduction

The goal of tax reform as outlined in previous chapters is to provide a state-local tax system that is equitable, efficient and productive and that contributes to the state's economic development. The purpose of this chapter is to outline a few simple but significant measures that will provide approaches to these goals. For economy in the presentation, the measures are examined in three progressive steps. In these steps the goals of adequacy, equity and efficiency are foremost.

More specifically the proposals would accomplish the established objectives as follows:

(1) As to adequacy, the proposed system would provide adequate revenues and would grow at least as fast as the state's economy, thus maintaining the public sector at its current relative size.

(2) As to equity, the burden (incidence) of the proposed system would be distributed proportionally among the individual taxpayers and taxing responsibility would be properly balanced among the state as well as the subdivisions. The impact of the proposed system would also be properly balanced between the individual and the business taxpayers. The business portion of the proposed tax system would be balanced among industries and adequate emphasis would be placed on each of the major tax sources--expenditures (consumption), income and wealth.

(3) As to economic efficiency, the proposed tax system would allow only a minimum of interference with the market allocation of the state's productive resources.

(4) As to simplicity, the proposed tax system would minimize the costs of administration and compliance. It is not meant that the program be implemented at once. It merely represents the ideal situation toward which state tax policy should be directed.

At this point, no proposal is made for the imposition of an individual income tax, though there can be no doubt that such introduction is highly desirable. In its absence the incidence of the state-local tax system will remain biased against the low-income taxpayer and, in effect, will redistribute after-tax income in favor of the high-income taxpayer.

Because the major tax emphasis in the near future seems destined to remain on the state's wealth and consumption (not income), little can be done in shifting the tax burden. One avenue, however, is open--"Circuit Breaker" tax relief can be granted to low-income taxpayers to remove much of the excess burden (beyond that borne by the middle-income taxpayers).

In general the proposed tax changes are designed to adjust business taxes to make the state more attractive to business and industrial development. In short the objective is to create a tax system in which taxes impact equally on all business firms. By this route business investment can be based on economic analyses and balanced economic development results. This, in turn, maximizes employment, income and, finally, the tax base.

Tennessee, like other states, has wide jurisdictional disparities in the ability to support public services. Therefore, in addition to tax reform, significant amounts of state revenues are suggested for return to local jurisdictions (cities, counties, schools) in the form of jurisdictionally equalizing grants.

It is not the intent of the proposals to redistribute the public decision-making authority or the administration of any public functions from the state to the local jurisdictions or from local jurisdictions to the state.

The Proposals

Table 6-1 lists the major state and local tax collections in 1977. This becomes the base for the statistical analysis of the proposals. They are presented in the following paragraphs, and statistically in Table 6-2.

The General Sales Taxes. In general two proposals would reduce sales tax collections and one would increase them. The major objective of the first two proposals is to equalize the tax impact on business firms and industries because some are much heavier users of the taxed items than others. The third proposal would equalize the taxes between goods sold in vending machines and those sold over-the-counter.

Proposal 1: Provide a general sales and use tax exemption for purchases of machinery and equipment by manufacturers, processors and assemblers.

Proposal 2: Repeal the general sales tax on purchases of power and fuels used directly in manufacturing, processing and assembling goods for resale.

Proposal 3: Repeal the gross receipts tax imposed by T.C.A., Title 67, Chapter 42, Item 65 and tax the receipts under the general sales tax laws, T.C.A., Title 67, Chapter 30.

Taxable purchases under Proposals 1 and 2 are now partially or fully exempt in about two-fifths of the states. They are now taxed at a 1½ percent rate in Tennessee. Cigarettes are taxed in vending machines at a rate of 2.5 percent and over-the-counter at 4.5 percent, plus the local tax of 1 to 1.5 percent. Other vending machine items are taxed at 1.5 percent in lieu of the state and local tax.

TABLE 6-1

STATE AND LOCAL TAX COLLECTIONS, BY SOURCE,
WITH PERCENTAGES OF TOTAL, 1976-1977
(In Thousands)

Tax Source	Amount			Percentage of Total
	State	Local	Total	
General Sales Taxes			$ 928,572	39.1
State	$ 730,672	$ --	730,672	30.8
Local	--	197,900	197,900	8.3
Selective Sales Taxes			157,125	6.6
Tobacco	67,829	900	68,729	2.9
Alcoholic Beverage	34,698	35,860	70,558	3.0
Mixed Drink	7,938	--	7,938	0.3
Public Utilities	--	6,500	6,500	0.3
Other	--	3,400	3,400	0.1
Income Taxes			178,427	7.5
Corporation	156,042	--	156,042	6.6
Individual	22,385	--	22,385	0.9
Motor Vehicle Related Taxes			332,734	14.0
Gasoline	166,982	--	166,982	7.0
Gasoline Inspection	34,219	--	34,219	1.4
M.V. Fuel	25,825	--	25,825	1.1
M.V. License	85,809	16,800	102,609	4.3
M.V. Title Fees	3,099	--	3,099	0.1
Property Related Taxes			673,766	28.4
Franchise	32,249	--	32,249	1.4
Inheritance & Estate	41,247	--	41,247	1.7
General Property	--	600,270	600,270	25.3
Other			102,977	4.3
Gross Receipts	41,963	--	41,963	1.8
Privilege	21,800	--	21,800	0.9
Business Gross Receipts	3,633	22,100	25,733	0.2
Corporation Filing Fees	615	--	615	--
Severance	--	1,966	1,966	0.1
Other, n.e.c.	--	10,900	10,900	1.4
TOTAL	$1,477,005	$896,596	$2,373,601	100.0%
Percent	62.2%	37.8%	100.0%	100.0%

SOURCE: Tennessee Department of Revenue and U. S. Bureau of the Census, unpublished data.

TABLE 6-2

STATE AND LOCAL TAX COLLECTIONS, BY SOURCE, AS PROPOSED TAX SYSTEM REVISION

	State	Local	Total	Percent of Total
General Sales Taxes	$ 730,672	$197,900	$	
Less (1)	(7,500)	--		
(2)	(12,400)	--		
Plus (3)	450	--		
Less (4)	(7,500)	--		
Plus (5)	--	23,125		
Net Collections	703,722	221,025	924,747	39.0
Selective Sales Taxes	102,527	--	102,527	4.3
Tobacco (7)	67,829	(900)[a]		
Alcoholic Beverages (7)	34,698	(35,860)[a]		
Mixed Drink (6)	(7,938)[a]	--		
Public Utilities (7)	--	(6,500)[a]		
Other (7)	--	(3,400)[a]		
Income Taxes				
Corporation	156,042	--	142,092	6.0
Less (75% of 8)	(1,500)	--		
(75% of 9)	(5,400)	--		
(75% of 10)	(7,050)	--		
Individual	22,385	--	24,215	1.0
Plus (14)	1,830	--		
Motor Vehicle Related Taxes	318,614	--	318,614	13.4
Gasoline	166,982	--		
Gasoline Inspection	34,219	--		
M.V. Fuel	25,825	--		
M.V. Licenses (7)	85,809	(16,800)[a]		
Plus (15)	2,680	--		
M.V. Title Fees	3,099	--		
Property Related Taxes	29,277	600,270	629,547	26.5
Corporation Franchise (12)	(32,249)[a]	--		
Inheritance and Estate	41,247	--		
General Property	--	600,270		
Less (18)	(11,970)	--		
Other Taxes	71,578	--	71,578	3.0
Gross Receipts	41,963	--		
Less (13)	(11,800)	--		
Privilege	21,800	--		

TABLE 6-2

(Continued)

	State	Local	Total	Percent of Total
Business Gross Receipts (14)	(3,633)[a]	(22,100)[a]		
Corporation Filing Fees	615	--		
Severance (15)	19,000	(1,966)[a]		
Other, N.E.C.	--	(10,900)[a]		
Adjusted Gross Receipts Taxes	164,931			
Less (25 percent of 8)	(500)	--		
(25 percent of 9)	(1,800)	--		
(25 percent of 10)	(2,350)	--		
Net Collections	160,281	--	160,281	6.8
Total Collections	$1,552,306	$821,295	$2,373,601	100.0
Shift in Collection Resp.	-75,301	+75,301		

SOURCE: Center for Business and Economic Research.

Proposal 4: Provide a "Circuit Breaker" sales tax relief graduated by income level for all low-income individuals and families.

"Rifling" the tax relief to "overburdened" individuals is significantly more efficient than using a "shotgun" approach, such as the general exemption food or other necessities. In light of the regressivity of the general sales taxes, a "Circuit Breaker" will accomplish the same degree of equalization with only a small reduction in net revenue.

Proposal 5: Provide that the local general sales tax base be identical to the state base.

Currently there is a limit on the tax for high priced items ($5 if the tax is 1 percent and $7.50 if the tax is 1.5 percent) and certain utility sales are not taxed locally. These limitations should be removed. An even more acceptable proposal would be to repeal the local general sales tax authority, increase the state tax rate and share the additional funds with local jurisdictions on a basis other than origin of the tax revenues. The base of the local tax is jurisdictionally capricious, giving some jurisdictions liberal funds and others a paucity of funds, in no way related to the expenditure obligations of the jurisdictions.

If these five proposals were implemented, the state tax revenues would have been reduced by approximately $27 million and local taxes increased by approximately $23.1 million in 1977 (Table 6-2).

The Selective Sales Taxes. Only one suggestion is made for change in state selective sales taxes. However, it is suggested that in the interest of simplicity (or efficiency of collection) local selective sales taxes be removed.

Proposal 6: Repeal the privilege tax on establishments selling mixed drinks or set-ups for mixed drinks imposed by TCA 67-4102, Item U, commonly known as the liquor by the drink tax.

The liability from this tax is unusually difficult to ascertain and revenue is minimal. The sales are also taxed under the general retail sales tax law.

Proposal 7: Repeal the authority for local governments to impose local selective sales taxes.

One jurisdiction now imposes a cigarette tax; alcoholic beverage tax, public utility taxes and other minor taxes are fairly common. In general they produce insignificant revenue and create collection problems.

The Property Tax. Three proposals are made concerning the property tax with the local fiscal impact unaffected thereby. Business property taxes on manufacturing inventories (Proposal 8) and taxes on machinery and equipment (Proposal 9) are relieved by a state tax credit. The state cost of these programs is reflected in reduced revenue from the corporation income and the adjusted gross receipts taxes in Table 6-2. A third proposal seeks a major equalization of the property tax among the Tennessee Counties (Proposal 10) by providing state tax credit for business real estate taxes generally above the median county rate. Its fiscal effects are also reflected in Table 6-10 in reduced corporation income and adjusted gross receipts taxes.

Proposal 8: Provide a tax credit for local property taxes paid by manufacturers, processors and assemblers on raw materials and goods in process against the total of taxes levied under T.C.A., Title 67, Chapter 27, the Excise Tax Law; T.C.A., Title 67, Chapter 30, the Retailer Sales Tax and the proposed modified gross receipts tax (Proposal 16).

Proposal 9: Provide for a tax credit for local property taxes paid by manufacturers, processors or assemblers on depreciable machinery and equipment against the total of taxes paid under T.C.A., Title 67, Chapter 27, the Excise Tax Law; Title 67, Chapter 30, the Retailer Sales Tax and the proposed modified gross receipts tax (Proposal 16).

Proposal 10: Provide a tax credit for county real property taxes paid at rates in excess of the states median county rate. The credit would be used only for real property used directly in manufacturing, processing or assembling goods for resale. It would be a credit against the total of taxes levied under T.C.A., Title 67, Chapter 27, the Excise Tax Law; Title 67, Chapter 30, the Retailer Sales Tax and the proposed modified gross receipts tax (Proposal 16).

The primary goal of these proposals is to equalize the tax across the counties and to remove the capriciousness of the tax among the various industries in the state.

The Income Taxes. In addition to the above suggestions, one other proposal affects the individual income taxes but not the corporation tax. Taxable dividends are taxed at 4 percent if 75 percent of total corporation property is taxed in Tennessee and 6 percent otherwise.

Proposal 11: All income taxable under T.C.A. 67, Chapter 26 should be taxed at a uniform 6 percent.

Revenue would be increased only minimally. Currently it is virtually impossible for a taxpayer to have information leading to the lower tax rate.

Other Taxes. Other taxes suggested for repeal are the corporation franchise tax, which is virtually a state corporation property tax (Proposal 12); a series of minor gross receipts taxes (Proposal 13); and the local business gross receipts taxes (Proposal 14).

Proposal 12: Repeal the corporation franchise tax as imposed by T.C.A., Title 67, Chapter 29.

Proposal 13: Repeal the gross receipts taxes imposed by T.C.A., Title 67, Chapter 41, Items B, H, N, Q, and R.

Proposal 14: Repeal the local business gross receipts tax imposed by T.C.A., Title 67, Chapter 58.

The franchise tax taxes the property (capital, surplus, individual profits) of corporations, but applies in no sense to unincorporated businesses. The taxes now imposed and suggested for repeal under Proposal 13 fall in the category of "nuisance" taxes. They generally apply to selected industries.

Item B: Bottlers and manufacturers of soft drinks.

Item H: Gas, water and electric companies.

Item N: Public utilities.

Item Q: Telephone and telegraph companies.

Item R: Theaters, motion pictures and vaudeville shows.

Rates vary from 3 percent of gross receipts on the utilities (including Items H, N, and Q) to 1 percent on Item R.

Proposal 15: Impose a general severance tax on minerals severed from the soil of Tennessee and repeal the current coal severance tax imposed by T.C.A. 67, Chapter 59.

This is a coal severance tax distributed to counties in which coal is mined for highway purposes. Because mineral wealth in the ground is inadequately appraised and taxed, an in-lieu tax should be levied. Moreover, many observers view natural resources as a resource that should be available to all the people and not accrued to the holder of the surface soil.

Recovery of Reduced Revenues. The reforms suggested above would result in reduced state and local revenues. Proposal 16 suggests that the reduced revenues should be recovered by imposing a flat rate privilege tax on all businesses and professions for their Tennessee adjusted gross income. Professions should be included because the professionals are, in fact, conducting business to sell their services. Moreover, their income is not taxed at the state and local level in Tennessee.

Proposal 16: Enact a flat rate privilege tax on business and professions. The base would be gross receipts minus the cost of goods sold or raw materials and net new investment in productive resources.

Considering the costs of goods sold or purchased for inclusion in assembling, processing or manufacturing goods for sale, a flat rate tax would affect all industries equally. Gross business profits measured in this way are assumed to be a good measure of the cost of government services to the various industries.

The Shift in Collection Responsibility. It will be noted in Table 6-2 that some collection responsibility is shifted to the state. It therefore becomes necessary to transfer funds back to the local jurisdictions since this is presumably where the expenditure obligations reside. Table 6-3 presents data showing the sharing of taxes in Tennessee under the current state-local tax system. If the balance in the last two columns of the table is to be maintained, an additional $79.5 million of state tax revenues must be shared in addition to the sharing under the revised tax program (Table 6-4).

Approximately two-thirds of this $79.5 million should go to replace local taxes repealed. Because most of these are based on consumption, it is suggested that 64.0 percent be distributed on the basis of state

TABLE 6-3

STATE AND LOCAL TAX COLLECTIONS AND SHARED TAXES,
CURRENT SYSTEM
(Dollars in Thousands)

Tax Source	Collections		Shared Taxes	Post-Transfer Funds	
	State	Local		State	Local
General Sales Taxes	$ 730,672	$197,900	$ 40,953	$ 690,072	$238,500
Selective Sales Taxes	110,465	46,660	9,775	100,690	56,435
Income Taxes					
Corporation	156,042	--	--	156,042	--
Individual	22,385	--	6,400	15,985	6,400
Motor Vehicle Related Taxes	315,934	16,800	92,467	223,467	109,267
Property Related Taxes	73,496	600,270	--	73,496	600,270
Other Taxes, N.E.C.	68,011	34,966	4,200	63,811	39,166
Total	$1,477,005	$896,596	$153,795	$1,323,563	$1,050,038

TABLE 6-4

STATE AND LOCAL TAX COLLECTIONS AND SHARED TAXES,
PROPOSED SYSTEM
(Dollars in Thousands)

Tax Source	Collections		Shared Taxes	Post-Transfer Funds	
	State	Local		State	Local
General Sales Taxes	$ 703,722	$221,025	$ 39,512	$ 664,210	$ 260,537
Selective Sales Taxes	102,527	--	6,140	96,387	6,140
Income Taxes					
Corporation	142,092	--	--	142,092	--
Individual	24,215	--	6,920	17,295	6,920
Motor Vehicle Related Taxes	318,614	--	92,467	226,147	92,467
Property Related Taxes	29,277	600,270	--	29,277	600,270
Other Taxes, N.E.C.	71,578	--	4,200	67,378	4,200
Adjusted Gross Receipts Taxes	160,281	--	--	160,281	--
General Revenue Sharing	--	--	--	-79,504	+79,504
Total	$1,552,306	$821,295	$149,239	$1,323,563	$1,050,038

sales tax collections (Table 6-5). In this table it is suggested that the sharing fund represents about 5.15 percent of Department of Revenue tax collections. Because the local coal severance tax is, in fact, a county highway tax, another 2.5 percent of the fund should replace the local revenues from the severance taxes. The remaining one-third (or 33.5 percent) could be allocated to cities and counties on the basis of population, then distributed in per capita amounts adjusted by an effort/ability index. This index is being developed in a separate report. This one-third of the fund would serve to equalize jurisdictional tax effort.

Individual Tax Burden Equalization. As a final step in the tax equalization process, it is necessary to equalize individual tax burdens within the state and local jurisdictions. As noted in an earlier statement, proportionality cannot be expected in the absence of an individual income tax. However, "Circuit Breakers" can accomplish much. Using data in Table 6-6 to implement the following formula accomplishes as much of the task as can reasonably be expected under the existing reluctance to impose an individual income tax. Property taxes on homesteads would be limited to a maximum of 2 percent or less of income, depending on the level of income. Sales tax relief would be granted in decreasing amounts per person as income increases.

The formula:

$$N \times P + PT - (R \times Y) = \text{Relief}$$

where: N = Number in taxpaying unit
P = Per person relief from Table 6-6
PT = Residential property tax
R = Maximum percent of income from Table 6-6
Y = family income level.

TABLE 6-5

BASIS FOR DISTRIBUTION OF 5.15 PERCENT OF STATE DEPARTMENT OF REVENUE TAX COLLECTIONS TO LOCAL JURISDICTIONS

Amount (1977)	Percentage of 5.15 percent	Basis
$51,164,000	64.0	State Sales Tax Collections, to both cities and counties.
1,999,000	2.5	Severance tax collections, to counties in which severance occurs.
26,781,000	33.5	Effort/ability index[a] to both cities and counties[b].
79,944,000	100.0	

a. An alternative distribution formula would be the federal general revenue distributions.

b. City and County allocations could be according to proportions of population.

TABLE 6-6

SCHEDULE OF "CIRCUIT BREAKER" GENERAL SALES AND PROPERTY TAX RELIEF

Income class	General Sales Tax Relief Per Person Relief	Property Tax Relief Maximum percent of income[a]
$ 0-$ 2,999	$15	0.5
3,000- 3,999	15	0.5
4,000- 4,999	14	1.0
5,000- 5,999	14	1.0
6,000- 6,999	13	1.25
7,000- 7,999	12	1.5
8,000- 9,999	10	2.0
10,000- 11,999	9	2.0
12,000- 14,999	7	2.0
15,000- 19,999	5	2.0
20,000 over	0	2.0

a. Amounts above these percentages would be relieved.

An example: N = 3; P = 15; PT = $105;
R = 0.5%; Y = $3,500, so that

3 x 15 + 105 - (.005 x $3,500) = Relief = $132.50

By this formula relief would be effectively cut off when income exceeded $10,000. Renters would be allowed to claim a portion of their residential rent as property taxes. The change in the estimated distribution of the tax burden is demonstrated in Table 6-7.

Summary. The above proposals are designed to achieve as fully as possible the objectives of adequacy, equity, efficiency and simplicity. Obviously trade-offs have been necessary and achievement is hindered because of certain alleged constitutional and political considerations. For example, an individual income tax is not proposed because it is alleged to be unconstitutional. Second, a state property tax is not suggested because it may be politically unacceptable. Both, however, need to be given considerable thought. They are discussed briefly below, along with other valuable considerations.

A State Property Tax

Possibly the most convincing argument against a state property tax is that the base should be reserved for local utilization. While this is a strong argument, it is not necessarily valid. Local jurisdictions refuse to reserve any particular tax base for state use. They are steadily encroaching on both the consumption and income tax bases. Thus the state need not feel restrained in entering the property tax arena.

There are some distinct advantages in having the state involved in the property tax programs. A state tax would provide for state involvement in the discovery, appraisal and assessment programs, leading to

TABLE 6-7

ESTIMATES OF DISTRIBUTION OF MAJOR STATE-LOCAL TAXES,
BY INCOME CLASS, PROPOSED TAX SYSTEM, 1977

Income Class	Current Distribution[a] (Percent)	Proposed Distribution[a] (Percent)
$ 0-$ 2,999	13.7	8.6
3,000- 3,999	10.6	6.8
4,000- 4,999	9.5	6.8
5,000- 5,999	8.4	6.5
6,000- 6,999	7.9	6.5
7,000- 7,999	7.5	6.5
8,000- 9,999	6.9	6.5
10,000- 11,999	6.3	6.3
12,000- 14,999	6.0	6.0
15,000- 19,999	5.3	5.3
20,000- 24,999	4.9	4.9
25,000 over	3.9	3.9
Ratio, Lowest/Highest	3.51	2.21

a. Percent of income paid in taxes.

SOURCE: Tables 5-4 and 5-10 this report.

increased jurisdictional and personal tax equity. In a recent article, it is maintained that much of the regressivity and capriciousness of the property taxes is due to weak performance of the tax administrators.[1] It is maintained here that more state involvement would improve performance.

Finally, a state property tax shared with local jurisdictions would be an efficient way to remove much of the capriciousness of the local tax base. To accomplish this tax sharing would need to be on a basis other than origin of the tax revenues. A state property tax and a reduced local property tax for public schools would be an improvement if the state tax is distributed by equalization formulas.

An additional property tax is always inferior to an individual income tax, however, because it is less responsive to economic growth and tends more toward regressivity.

The Individual Income Taxes

Because Tennessee does not employ a broad-based progressive individual income tax, its tax base remains relatively unresponsive and inequitable when compared with the average state. Only a massive and perhaps unacceptable amount of "Circuit Breaker" type tax relief would remove the regressivity of a tax system so strongly dominated by consumption and wealth taxes.

While conclusions as to whether a progressive or a regressive tax system is more favorable for economic development are debatable, there

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1. David E. Black, "Property Tax Incidence: The Excise-Tax Effect and Assessment Practices," National Tax Journal, Vol. XXX, No. 4, December 1977, pp. 429-434.

is widespread support for a tax system balanced among consumption, income and property taxes as a matter of social equity. This has been suggested in earlier Chapters of this report but not achieved in the proposals, nor has a preferred responsiveness been achieved. It was stated that 20 to 30 percent of the state-local taxes should be raised by a tax on individual income to achieve the two objectives of unitary responsiveness and proportionality. In Tennessee, where government operations are traditionally limited, this would mean a very modest income tax burden and a substantially reduced tax burden on consumption and property. While property taxes are not excessively high in Tennessee, dependence on consumption taxes is well above the national average. Balance can be restored only with a broad-based income tax.

It is not recommended that a local income tax be authorized along with the state tax. The base of a local tax is just as jurisdictionally capricious as that of general sales or property taxes. The base is concentrated in wealthy jurisdictions so that revenues do not coincide with local expenditure obligations. A local piggy-back tax on the state base, using a uniform rate or a rate based on state liability, is probably more desirable than a local piggy-back general sales tax such as is used in Tennessee. In this form it is jurisdictionally capricious but the incidence is either proportional or as progressive as the state tax. A local payroll tax is both capricious and regressive in that it taxes only earned income according to the origin of the tax revenues.

Other Pertinent Comments on Tax Reform and Modernization

Most of Tennessee's tax laws have been in force for several decades. During these decades they have been subjected to numerous

amendments and economic and social organizations have changed. Substantial effort has been made in the last three years to modernize the language and procedures of the statutes to conform to current business organization and practice. Most notably the franchise and excise tax laws, the petroleum tax laws, the tobacco tax laws and the death tax laws have been extensively rewritten. So also were the alcoholic beverage tax laws, but this rewrite failed to gain legislative approval.

A major effort should be made to rewrite the general sales tax laws. In this tax law, as well as in other tax statutes, the allocation and distribution formulas for sharing revenues with local governments and in earmarking funds for specific purposes should be modernized and simplified.

Finally there should be serious study as to the feasibility of applying a value tax to motor vehicle fuels, alcoholic beverage and tobacco products. The fact that these are volume taxes (rate per gallon or per package) inhibits their growth. Taxes do not react to price increases, only volume increases. Thus the taxes are among the least responsive in the state tax repertory. Value taxes are the rule rather than the exception in state taxation. Consumption, income and sales taxes all react to price changes as well as changes in physical activity. Because of the dual influences on tax revenues, value taxes tend to be more responsive than volume taxes. Because they are also regressive the shift from volume to value tax bases would not advance the cause of tax progression.

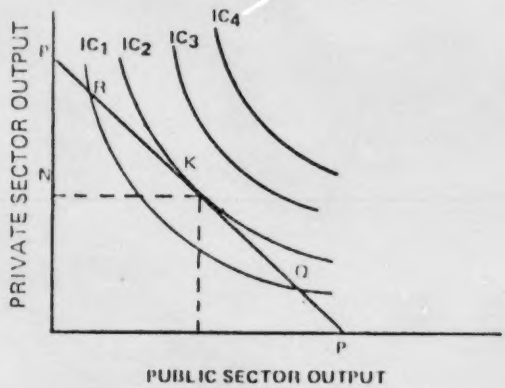
APPENDIX A

THE RELATIVE SIZE OF GOVERNMENT

In an aggregate sense, the optimum intersectoral allocation of economic activity can be demonstrated by use of indifference curve analyses or by marginal utility analysis.

In the first approach, a schedule of various combinations of private and public sector goods that can be produced with existing resources at full employment can be constructed. Somewhere on this production-possibility schedule, there is a point at which the mix of private and public goods and services is optimized. This is represented by the tangency of an indifference curve with the production possibility schedule as shown in Figure 1. Output is limited by resources and any other combination of public and private goods would reduce public welfare.

Figure 3



NOTE: PP (production-possibility) schedule represents all combinations of public and private goods possible, given the state's economic resources. IC_1, IC_2, IC_3, IC_4 are indifference curves representing different levels of public welfare.

As we move from IC_1 to IC_4, the level of public welfare rises, but it is constant along each curve. The highest level of public welfare possible is at K, with OM of public sector output and ON of private sector output. If more or less of public output is provided (if the public sector contracts or expands, given current resource capacity), we move from IC_2 to a lower level of welfare (toward IC_1). Point Q (more public sector output) is on a lower IC (lower public welfare). Point R (more private sector output) also reduces public welfare because we have moved to a lower level (curve) of welfare.

In the second approach, the gain in welfare (utility) of a resource employed in the public sector can be compared with the loss in welfare (disutility) as the unit is withdrawn from the private sector (taxes). If there is a net gain in welfare by the transfer (utility gain due to the increase in public services is greater than disutility due to the decrease in the private sector activity), total welfare is enhanced. If there is a reduction in public welfare by the transfer of a resource unit at the margin, there is a reduction in total welfare. When the optimum intersectoral allocation is reached, total welfare will be reduced by a shift of economic resources either from or to the public sector.